

[JOINT COMMITTEE PRINT]

**PROPOSALS AND ISSUES
RELATING TO TAX INCENTIVES
FOR ENTERPRISE ZONES**

**SCHEDULED FOR A HEARING
BEFORE THE
SENATE COMMITTEE ON FINANCE
ON JUNE 3, 1992**

**PREPARED BY THE STAFF
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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on June 3, 1992, on issues relating to enterprise zone tax incentives.

This pamphlet,¹ prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of enterprise zone proposals contained in several introduced bills. Part I is a summary. Part II is a brief description of related present-law provisions. Part III is a description of the enterprise zone provisions contained in S. 2217, S. 1920, S. 1603, S. 1032, and H.R. 4210, and other proposals relating to enterprise zones, including S. 686 ("Rural Business Revitalization Act of 1991") and S. 383 ("Indian Economic Development Act of 1991"). Part IV discusses issues relating to proposed tax incentives for economic activity located in enterprise zones.

¹ This pamphlet may be cited as follows: Joint Committee on Taxation, *Proposals and Issues Relating to Tax Incentives for Enterprise Zones* (JCS-12-92), June 2, 1992.

For prior coverage of this topic see Joint Committee on Taxation, *Description of S. 1310 Urban Jobs and Enterprise Zone Act of 1981* (JCS-33-81), July 10, 1981; Joint Committee on Taxation, *Description of S. 2298 Enterprise Zone Tax Act of 1982* (JCS-9-82), April 13, 1982; Joint Committee on Taxation, *Description of Bills (S. 863, S. 98, and S. 634) Relating to Enterprise Zones* (JCS-7-83), April 20, 1983; Joint Committee on Taxation, *Description of Enterprise Zone Proposals (H.R. 6 and Administration Proposal)* (JCS-16-89), October 14, 1989; and Joint Committee on Taxation, *Description and Analysis of Proposals Relating to Tax Incentives for Enterprise Zones (H.R. 11, H.R. 23, and Other Proposals)* (JCS-9-91), June 18, 1991.

I. SUMMARY

Present Law

Tax incentive provisions

Targeted geographic areas

The Internal Revenue Code does not contain general rules that target specific geographic areas for special Federal income tax treatment. Within certain Code sections, however, there are definitions of targeted areas for limited purposes. For example, the provisions relating to qualified mortgage bonds define targeted areas for the purpose of promoting housing development within economically distressed areas. Similarly, for purposes of the low-income housing credit, certain geographic areas are designated as high cost or difficult to develop areas for the purpose of increasing the rate of credit applicable to such areas. In addition, present law provides favorable Federal income tax treatment for certain U.S. corporations that operate in Puerto Rico, the U.S. Virgin Islands, or a possession of the United States as a means to encourage the conduct of trades or businesses within these areas.

Tax credits for employers

Under present law, the income tax liability of an employer does not vary based on where an employee performs services on behalf of the employer. The targeted jobs tax credit under present law, however, provides an income tax credit to employers for a portion of the wages paid to certain employees, who generally are either economically disadvantaged or participating in a specific education or rehabilitation program.

Tax credits for employees

Under present law, the income tax liability of an employee does not vary based on where the employee performs services in the United States on behalf of an employer. However, an eligible individual who maintains a home for one or more qualifying children is allowed an advance refundable income tax credit based on the earned income of the individual and the number of qualifying children.

Tax credits for investment

An income tax credit is allowed under present law for certain expenditures incurred in rehabilitating certified historic structures and certain nonresidential buildings that were originally placed in service before 1936. In addition, under present law, an income tax credit is allowed in annual installments over 10 years for certain expenditures incurred in substantially rehabilitating or constructing qualifying low-income rental housing. Under prior law, a 10-

percent investment tax credit was allowed for the cost of eligible tangible personal property that was used in a trade or business or for the production of income.

Capital gains

Net capital gains are taxed as ordinary income under present law, subject to a maximum marginal rate of 28 percent in the case of individuals. Before 1987, net capital gains were taxed at a reduced rate. All taxpayers other than corporations could reduce net capital gains by 60 percent, and the remainder was taxed as ordinary income—effectively establishing a maximum 20-percent tax rate. The maximum tax rate for net capital gains of corporations was 28 percent.

Private activity bonds

Although interest on State or local government bonds used to finance trade or business activity generally is taxable, various exceptions are provided for what are termed private activity bonds. These include bonds issued as qualified small-issue bonds, as qualified redevelopment bonds, or to finance certain other private activities. Tax-exempt private activity bonds generally are subject to State volume limitations.

Non-tax provisions

Foreign trade zones

A foreign trade zone may be established within any port of entry. Duties are not levied on goods imported into a foreign trade zone until the time that the goods leave the foreign trade zone for shipment to other areas of the United States.

Regulatory flexibility

Under present law, government agencies must follow certain procedures in promulgating regulations that are designed to ease the regulatory burden on small businesses, small nonprofit organizations, and small governmental jurisdictions.

Summary of S. 2217, S. 1920, S. 1603, and S. 1032

In general

S. 2217, S. 1920, S. 1603, and S. 1032 are substantially similar (except as otherwise indicated below), and also are substantially similar to the enterprise zone proposal contained in the President's fiscal year 1993 budget proposals.

Designation of enterprise zones

The bills would authorize the Secretary of Housing and Urban Development (HUD) to designate up to 50 enterprise zones from areas nominated by State and local governments (and Indian reservation governing bodies). The designations would be made over a four-year period, with not more than 15 designations being made during each of the first three years, and 5 in the last year. Designation of an area as an enterprise zone generally would be effective for 25 years.

Tax incentives for enterprise zones

Employee wage credit

The bills would provide a 5-percent refundable tax credit to enterprise zone employees for the first \$10,500 of wages. The maximum credit would be \$525; it would be phased out between \$20,000 and \$25,000 of total wages. The credit would be reduced for individuals subject to the alternative minimum tax.

Deduction for purchase of enterprise zone stock

Under the bills, individuals could elect to deduct up to \$50,000 per year of the purchase price of certain enterprise zone stock, subject to a \$250,000 lifetime limitation.² Stock would qualify for this deduction only if the issuing corporation used the proceeds from the stock issuance to acquire qualified enterprise zone property within 12 months following issuance. Any gain on the sale of the stock would be recaptured as ordinary income. In addition, the tax benefit of the deduction would be reduced if the stock were held less than five years when sold. The deduction would be treated as a preference for purposes of the alternative minimum tax (except under S. 1920).

Exclusion of enterprise zone capital gain

The bills would exclude from income certain long-term capital gain realized from the disposition of enterprise zone property (generally including real property and tangible personal property). The property must have constituted enterprise zone property for at least two years prior to disposition. Only gains attributable to periods that the property was used in an enterprise zone business would be eligible for the exclusion. The gain exclusion would not be a preference for purposes of the alternative minimum tax.

Other provisions

Preference in establishment of foreign trade zones

The bills would require the Foreign Trade Zone Board to consider on a priority basis the processing of any applications that involve the establishment of a foreign-trade zone in an enterprise zone. Similarly, the Secretary of the Treasury would be required to consider on a priority basis the processing of any application that involves the establishment of a port of entry that is necessary to permit the establishment of a foreign-trade zone in an enterprise zone.

Regulatory flexibility

The bills would expand the definition of a small entity for purposes of the Regulatory Flexibility Act to include any qualified enterprise zone business, and certain other enterprises.

Repeal of Title VII of 1987 Housing Act

The bills would repeal Title VII of the Housing and Community Development Act of 1987.

² Under S. 1920, the annual limitation would be \$100,000, subject to a \$500,000 lifetime cap.

Summary of H.R. 4210

In general

H.R. 4210 ("Tax Fairness and Economic Growth Act of 1992"), as reported by the committee of conference (H. Rept. 102-461), contained provisions establishing an enterprise zone demonstration program. The bill was passed by the House of Representatives and the Senate on March 20, 1992, but was vetoed by the President on that date.

Designation of tax enterprise zones

H.R. 4210 would authorize the designation of 35 tax enterprise zones from areas nominated by State and local governments (and Indian reservation governing bodies). The Secretary of HUD would be authorized to designate 10 areas as urban tax enterprise zones, and the Secretary of Agriculture would be authorized to designate 25 areas as rural development investment zones. Designation of an area as a tax enterprise zone generally would be effective for 15 years.

Tax incentives for tax enterprise zones

Employer wage credit

The bill would provide certain small employers with a credit equal to 7.5 percent of qualified enterprise zone wages paid to an individual who (1) does not receive annual wages or salary exceeding \$30,000, (2) resides in the zone, and (3) performs substantially all services for the employer's trade or business within the zone. The credit would be a general business credit and, as such, could not reduce an employer's tentative minimum tax.

Deduction for purchase of enterprise zone stock

Under H.R. 4210, individuals could elect to deduct up to \$25,000 per year of the purchase price of certain enterprise zone stock, subject to a \$250,000 lifetime limitation. Stock would qualify for this deduction only if the issuing corporation used the proceeds from the stock issuance to acquire qualified enterprise zone property within 12 months following issuance. Any gain on the sale of the stock would be recaptured as ordinary income. In addition, the tax benefit of the deduction would be reduced if the stock were held less than 10 years when sold. The deduction would be treated as a preference for purposes of the alternative minimum tax.

Additional first-year depreciation allowance

An additional depreciation allowance equal to 25 percent of the adjusted basis of certain qualified zone property (generally tangible personal property and real property other than buildings) would be allowed for the taxable year that the property is placed in service in an active trade or business in an enterprise zone. The additional depreciation allowance would not be a preference for purposes of the alternative minimum tax.

Limitation on tax incentives

H.R. 4210 would impose an overall limitation on the amount of tax incentives available in each tax enterprise zone for each calendar year. Each urban tax enterprise zone would be subject to a maximum annual limitation of \$14.3 million, and each rural development investment zone would be subject to a maximum annual limitation of \$5.5 million. The local governments and the State in which a tax enterprise zone is located would be required to designate a government official who would be responsible for allocating the tax incentives of the zone among taxpayers. Unused allocations of tax incentives could be carried forward (with certain limitations).

Studies

H.R. 4210 would require the Secretary of the Treasury and the Comptroller General to conduct separate studies on the effectiveness of the tax enterprise zones provided for by the bill. An interim report of each study would be required to be submitted not later than July 1, 1996, and a final report by July 1, 2001, to the House Committee on Ways and Means and the Senate Committee on Finance.

Summary of S. 686

Designation of rural enterprise zones

S. 686 would authorize the Secretary of the Treasury to designate certain rural areas as rural enterprise zones. The bill would not limit the number of areas that could be designated as rural enterprise zones. Zone designations generally would be effective for 15 years.

Tax incentives for rural enterprise zones

Employer wage credit

The bill would provide a 10-percent tax credit to employers in rural enterprise zones for certain wages paid to qualified employees who perform at least 50 percent of their services for the employer during the taxable year in a zone. The 10-percent credit would apply to (1) the amount of qualified wages paid by an employer in a rural enterprise zone during a taxable year that exceeds the qualified wages paid during the 12 months prior to the date the zone was designated, and (2) wages paid employees during any portion of the taxable year during which the employer is training or retraining such employees.

Investment tax credit

The bill would provide a 10-percent tax credit for certain personal property and depreciable real property placed in service during a year in which an area qualifies as a rural enterprise zone and used in an active enterprise zone trade or business. The credit would be subject to the present-law general business credit limitations.

Increased research credit

The bill would provide a 40-percent credit rate (in lieu of the present-law 20-percent credit rate) for qualified research expenditures that exceed a taxpayer's base amount with respect to research conducted in a rural enterprise zone.

Deferral of capital gain reinvested in zone property

The bill would allow taxpayers to defer the recognition of long-term capital gain from the sale or exchange of any property up to 10 years if the amount realized from the sale or exchange is used to purchase certain property used in the active conduct of a trade or business in a rural enterprise zone. The capital gain deferral would not be a preference for purposes of the alternative minimum tax.

Summary of S. 383

Designation of Indian enterprise zones

S. 383 would authorize the Secretary of Housing and Urban Development to designate up to 12 Indian enterprise zones between 1992 and 1995. The designation of an area as an Indian enterprise zone generally would be effective for 25 years.

Tax incentives for Indian enterprise zones

The proposed tax incentives for Indian enterprise zones would include the following: (1) an employment tax credit generally equal to 10 percent of wages and health insurance costs; (2) a capital gains deferral of up to 10 years for amounts reinvested in Indian enterprise zone property; (3) a 25-percent tax credit for constructing child care facilities; and (4) a tax credit for a portion of the Federal income taxes attributable to income from Indian enterprise zone business. The bill would limit the amount of annual tax incentives that would be available within an Indian enterprise zone.

The bill would also permanently extend the authority to issue qualified small issue bonds for Indian enterprise zones.

Other provisions

The bill would give preference to the establishment of foreign-trade zones within designated Indian enterprise zones. In addition, the bill would require the Secretary of the Treasury and the Comptroller General each to prepare a study on the overall impact of the bill, and to submit their studies not later than July 1, 1995, to the House Committee on Ways and Means and the Senate Committee on Finance.

Summary of Issues Relating to Tax Incentives for Enterprise Zones

Effect of tax incentives on the location of investments

In theory, favorable tax treatment of investment and employment within a specified geographic area should induce more economic activity to be located within that area. Because there are no Federal programs offering tax incentives targeted at specific geographic areas (other than Puerto Rico and other U.S. possessions), existing analysis has attempted to examine the effects of State and

local financial incentives on location decisions. Econometric evidence on the effects of such programs on location decisions is inconclusive.

Surveys of business managers usually conclude that tax and other financial inducements are of secondary importance to a firm's location decision. However, many economists suggest caution in interpreting the findings of survey research because responses to survey questions may not accurately forecast the economic behavior of decision makers.

Some case study analyses of business location decisions have concluded that financial incentives are relatively important to the decision. Others have concluded that such incentives are relatively unimportant.

Efficiency and neutrality of tax incentives for enterprise zones

If investment in enterprise zones merely replaces investment that would have taken place elsewhere, the primary effect of the investment incentives would be redistributive. If the investment is redistributed from local labor markets with low unemployment to local labor markets with high unemployment, the incentives may generate efficiency gains for the economy as under-utilized resources are tapped.

Preferential tax treatment for certain investments or for employment within enterprise zones creates economic inducements that may lead to an inefficient allocation of resources. Such efficiency losses must be weighed against the social goal of increasing economic growth and opportunity in distressed areas.

Incidence of enterprise zone benefits

The ultimate division of the tax benefits associated with enterprise zones among the potential beneficiaries depends on demand and supply conditions in the affected markets and the particular characteristics of the proposals. In general, the incidence of a tax (or subsidy) falls most heavily on the factor of production that is least mobile. Within an enterprise zone, land is an immobile factor and it may be expected that tax benefits granted for economic activity undertaken in an enterprise zone will tend to result in higher prices for land in the enterprise zone. Persons living within the enterprise zone or employed within the enterprise zone and entrepreneurs also may gain some of the tax benefits provided.

Complexity

Proposals to create tax preferences for taxpayers located within certain geographic areas may create complexity for both taxpayers and tax administrators. Such complexity may impose a relatively larger burden on small businesses and individual taxpayers than on larger businesses.

II. PRESENT LAW

Tax incentive provisions

Targeted geographic areas

The Internal Revenue Code does not contain general rules that target specific geographic areas for special Federal income tax treatment. Within certain Code sections, however, there are definitions of targeted areas for limited purposes. For example, targeted areas are defined under the qualified mortgage bond provisions of the Code as a means to promote housing development within economically distressed areas. Within these areas, which are defined on the basis of the income of area residents or the general economic conditions of the area, the rules for the financing of owner-occupied homes with qualified mortgage bonds are less restrictive than the generally applicable rules. Similarly, for purposes of the low-income housing credit, certain geographic areas are designated as high cost or difficult to develop areas. In these areas, the amount of the low-income housing credit is 130 percent of the amount that would otherwise be allowed.

In addition, present law provides favorable Federal income tax treatment for certain U.S. corporations that operate in Puerto Rico, the U.S. Virgin Islands, or a possession of the United States. Under these rules, a U.S. corporation that satisfies certain conditions may elect to eliminate U.S. tax on certain foreign source income that is related to the operation of a trade or business in Puerto Rico, the U.S. Virgin Islands, or a possession of the United States. These special rules were enacted in order to encourage U.S. corporations to establish and maintain trades or businesses within these areas.

Tax credits for employers

Under present law, the income tax liability of an employer does not vary based on where an employee performs services on behalf of the employer. The targeted jobs tax credit under present law, however, provides a tax credit for a portion of the wages paid to individuals from nine targeted groups. These groups generally are defined according to the individual's physical condition, participation in a specified education or rehabilitation program, or economic status.

The credit generally is equal to 40 percent of the first \$6,000 (or, in the case of a qualified summer youth employee, \$3,000) of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit allowed with respect to any employee general-

ly is limited to \$2,400. The employer's deduction for wages must be reduced by the amount of the credit claimed.³

Tax credits for employees

Under present law, the income tax liability of an employee does not vary based on where the employee performs services in the United States on behalf of an employer. However, an eligible individual who maintains a home for one or more qualifying children is allowed an advance refundable income tax credit based on the earned income of the individual and the number of qualifying children. For 1991, the earned income tax credit equals 16.7 percent (in the case of an individual with one qualifying child) or 17.3 percent (in the case of an individual with two or more qualifying children) of the first \$7,140 of earned income.⁴ For 1991, the credit begins to be phased out if adjusted gross income (or, if greater, earned income) exceeds \$11,250 and is completely phased out if adjusted gross income (or, if greater, earned income) exceeds \$21,240.

In addition to the regular earned income tax credit, present law provides for two supplemental credits: a supplemental young child credit for taxpayers with a qualifying child under the age of one (a 5-percent credit rate), and a supplemental health insurance credit for taxpayers who purchase insurance coverage for their qualifying children (a 6-percent credit rate). These supplemental credits are computed using the same earned income base (including phaseouts) as is the regular earned income tax credit.

Tax credits for investment

An income tax credit is allowed under present law for certain expenditures incurred in rehabilitating certified historic structures and certain nonresidential buildings that were originally placed in service before 1936. The credit rate is 20 percent for expenditures incurred in rehabilitating certified historic structures and 10 percent for expenditures incurred in rehabilitating buildings originally placed in service before 1936. The basis of any building with respect to which the rehabilitation credit is claimed is reduced by the full amount of the credit.

Before 1986, a 10-percent investment tax credit was allowed for the cost of eligible tangible personal property that was used in a trade or business or for the production of income. The basis of the property was reduced by one-half of the amount of the credit. The investment tax credit was not allowed with respect to real property.

Low-income housing tax credit

An income tax credit is allowed in annual installments over 10 years for qualifying low-income rental housing. Both substantially rehabilitated existing housing and newly constructed housing are eligible for the credit. The credit percentage is adjusted monthly to maintain a present value of 70 percent for the costs of most new

³ Under present law, the targeted jobs tax credit is scheduled to expire after June 30, 1992. The President's fiscal year 1993 budget proposal would extend the credit for 18 months (i.e., the credit would expire after December 31, 1993).

⁴ For 1994, these credit percentages are scheduled to be 23 percent for individuals with one qualifying child and 25 percent for individuals with two or more qualifying children.

construction and rehabilitation. The credit percentage (similarly adjusted) has a present value of 30 percent for the costs of acquiring existing property that is substantially rehabilitated and for creditable costs associated with property that receives other Federal subsidies (e.g., property that is financed with the proceeds of tax-exempt bonds).

Housing projects qualify for the credit only if one of two low-income tenant occupancy requirements is continuously satisfied for a period of 30 years (a 15-year compliance period followed by a 15-year extended use period). These restrictions require that (1) at least 20 percent of the housing units be occupied by individuals having incomes of 50 percent or less of the area median gross income or (2) at least 40 percent of the units be occupied by individuals having incomes of 60 percent or less of the area median gross income.

The basis on which the tax credit is claimed is equal to the "qualified basis" in the project, defined as the basis of the housing units actually occupied by low-income tenants plus an allocable share of the basis of common elements. No credit is allowed for the basis of (1) housing units occupied by nonqualifying tenants, (2) common elements allocable to such units, or (3) other facilities.⁵

Expensing of certain investments

There is no provision under present law that allows the amount of an investment to be expensed (i.e., deducted for the year in which the investment occurs) based on the location of the investment. Present law, however, provides that in lieu of depreciation deductions, a taxpayer (other than an estate or trust) may elect to deduct all or a portion of the cost of qualifying property for the taxable year in which the property is placed in service. The maximum amount that may be expensed under this provision for any taxable year is \$10,000. In general, qualifying property is any tangible personal property that is predominantly used in the active conduct of a trade or business.

Depreciation deductions

The depreciation deduction for any tangible property used in a trade or business or for the production of income is determined under the accelerated cost recovery system as modified by the Tax Reform Act of 1986. Under this system, the depreciation deduction for nonresidential real property generally is determined by using the straight line method and a recovery period of 31.5 years and the depreciation deduction for residential real property generally is determined by using the straight line method and a recovery period of 27.5 years. The depreciation deduction for tangible personal property generally is determined by using a recovery period that is based on the class life of the property and the 200-percent (or 150-percent) declining balance method (with a switch to the straight line method for the taxable year that the straight line method yields a higher depreciation deduction).

⁵ Under present law, the low-income housing tax credit is scheduled to expire after June 30, 1992. The President's fiscal year 1993 budget proposal would extend the credit for 18 months (i.e., the credit would expire after December 31, 1993).

Nonrecognition provisions

A sale or exchange of an asset generally is a taxable event. In a number of instances, however, gain or loss realized by a taxpayer upon the sale or exchange of an asset is not recognized for Federal income tax purposes. For example, no gain or loss is recognized if property held for productive use in a taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that also is to be held for productive use in a trade or business or for investment. As another example, a taxpayer generally may defer recognition of gain on the sale of a principal residence if the sales price of the old residence is reinvested in a new principal residence within a specified period of time. Present law does not provide for nonrecognition of gain or loss in the case of the sale or exchange of an asset solely because the asset is located within a particular economically distressed area.

Capital gains

Net capital gains are taxed as ordinary income under present law, subject to a maximum marginal rate of 28 percent in the case of individuals. In general, a capital asset is any property held by the taxpayer except certain specified types of property, such as inventory or property held primarily for sale to customers in the taxpayer's trade or business. Before 1987, net capital gains were taxed at a reduced rate. All taxpayers other than corporations could reduce net capital gains by 60 percent, and the remainder was taxed as ordinary income—effectively establishing a maximum 20-percent tax rate on this income (40 percent of the gain included in income multiplied by a 50-percent maximum marginal income tax rate). The maximum tax rate for net capital gains of corporations was 28 percent. This reduction in tax was treated as a preference item for purposes of the minimum tax.

Private activity bonds

Although interest on State or local government bonds used to finance trade or business activity generally is taxable, various exceptions are provided. For example, interest on State or local government bonds generally is tax-exempt if the bonds are qualified small-issue bonds (used to finance manufacturing facilities or property acquired by first-time farmers)⁶ or qualified redevelopment bonds. Tax-exempt private activity bonds issued by State and local governments generally are subject to State volume limitations. In addition, the depreciation deduction for property financed with tax-exempt bonds generally is determined by using the straight line method over the class life of the property.

Losses with respect to certain securities

The loss resulting from the worthlessness of a stock, bond, or other evidence of indebtedness issued by a corporation is generally treated as a loss from the sale or exchange of a capital asset. Consequently, the loss is subject to the general rules that limit the

⁶ Under present law, the authority to issue qualified small-issue bonds is scheduled to expire after June 30, 1992. The President's fiscal year 1993 budget proposal would extend the authority to issue first-time farmer bonds for 18 months (i.e., through December 31, 1993).

amount of capital losses that may be allowed as a deduction for any taxable year.⁷

If an individual incurs a loss with respect to certain small business stock, the loss is treated as an ordinary loss rather than a capital loss. The maximum amount that may be treated as an ordinary loss for any year under this provision is limited to \$50,000 (\$100,000 in the case of spouses who file a joint return).

Non-tax provisions

Foreign trade zones

A foreign trade zone may be established within any port of entry. Duties are not levied on imported goods shipped into a foreign trade zone until the time that the goods leave the foreign trade zone for shipment to other areas of the United States. The Foreign Trade Zone Board is responsible for approving applications for the establishment of foreign trade zones, while the Secretary of the Treasury is responsible for approving applications for the establishment of ports of entry.

Designation of enterprise zones under the Housing and Community Development Act of 1987

Pursuant to the Housing and Community Development Act of 1987, the Secretary of Housing and Urban Development (HUD) may designate not more than 100 nominated areas as enterprise zones (42 U.S.C. sec. 11501 et. seq.).⁸ An area may be so designated after being nominated by one or more local governments and the State or States in which it is located, and after the Secretary of HUD consults with (1) the Secretaries of Agriculture, Commerce, Labor, and the Treasury, (2) the Director of the Office of Management and Budget, (3) the Administrator of the Small Business Administration, and, (4) in the case of an area on an Indian reservation, the Secretary of Interior. An enterprise zone designation is to remain in effect for 24 years (or until an earlier termination date designated by the State or local government, or until the designation is revoked by the Secretary of HUD).

A nominated area may be designated as an enterprise zone only if it meets the following requirements: (1) the boundary of the area is continuous; (2) the area has a population of not less than 4,000 if any portion of the area (excluding certain qualifying rural areas) is located within a metropolitan statistical area with a population of 50,000 or more; and (3) the area's population is at least 1,000, or the area is entirely within an Indian reservation. In addition, the State and local governments (or Indian reservation governing body) must certify, and the Secretary of HUD must accept such certification, that (1) the area is one of pervasive poverty, unemployment, and general distress; (2) the area is located wholly within the jurisdiction of a local government that is eligible for Federal assistance under section 119 of the Housing and Community Development Act of 1974; (3) the unemployment rate is at least 1.5 times the national

⁷ Generally, an individual may use no more than \$3,000 per year in net capital losses to offset ordinary income. Unused net capital losses may be carried forward indefinitely.

⁸ Prior to January 1, 1989, HUD received 270 nominations of areas seeking to be designated as enterprise zones. Thus far, no area has been designated as an enterprise zone.

unemployment rate; (4) the poverty rate within the area is at least 20 percent; and (5) either (a) at least 70 percent of the households in the area have incomes below 80 percent of the median income of households of the local government, or (b) the population of the area decreased by 20 percent or more between 1970 and 1980.

At least one-third of the enterprise zones must be within rural areas, meaning such areas (1) are within a local government jurisdiction(s) with a population of less than 50,000, (2) are outside of a metropolitan statistical area, or (3) are determined by the Secretary of HUD, after consultation with the Secretary of Commerce, to be rural areas.⁹

No area may be designated as an enterprise zone unless the local government and the State (or, in the case of a nominated area on an Indian reservation, the reservation governing body) in which the area is located agree in writing that, during any period during which the area is an enterprise zone, such governments will follow a specified course of action designed to reduce the various burdens borne by employers or employees in such area, including, but not limited to: (1) a reduction of tax rates or fees applying within the area; (2) an increase in the level of public services, or in the efficiency of the delivery of public services, within the area; (3) actions to reduce or simplify paperwork requirements within the area; (4) program involvement by public authorities, private entities, organizations, neighborhood associations and community groups, particularly those within the area (including a commitment to provide jobs and job training for, and technical, financial, and other assistance to, employers, employees and residents of the area); (5) providing special preference to contractors owned and operated by minorities; and (6) providing surplus land in the area to neighborhood organizations agreeing to operate a business on the land.

⁹ A rural area may be designated as an enterprise zone only if it is certified as being an area of pervasive poverty, unemployment, and general distress; but such a rural area need not satisfy all of the specific criteria which a non-rural area must satisfy to be designated an enterprise zone.

III. DESCRIPTION OF PROPOSALS

A. Description of Enterprise Zone Provisions of S. 2217 (Enterprise Zone-Jobs Creation Act of 1992),¹⁰ S. 1920 (Economic Growth and Family Tax Freedom Act of 1991),¹¹ S. 1603 (Economic Growth Act of 1991),¹² and S. 1032 (Enterprise Zone-Jobs Creation Act of 1991)¹³

Designation of enterprise zones

The enterprise zone provisions contained in S. 2217, S. 1920, S. 1603, and S. 1032, are substantially similar (except as otherwise indicated below).¹⁴ Under these bills, up to 50 enterprise zones would be designated over a four-year period from areas nominated by State and local governments.¹⁵ The Secretary of HUD would begin to make the designations four months after the date of enactment of the legislation. Not more than 15 designations would be made during the first 12 months, not more than 30 within 24 months, not more than 45 within 36 months, and not more than 50 within 48 months.

Under the bills, a nominated area (other than a rural area) would be eligible to be designated as an enterprise zone only if the area: (1) has a continuous boundary with a population of at least 4,000 (1,000 for enterprise zones located within a metropolitan statistical area with a population of less than 50,000); (2) has pervasive poverty, unemployment, and general distress; (3) is located within a jurisdiction that is eligible for Federal assistance under section 119 of the Housing and Community Development Act of 1974; (4) has an unemployment rate of at least 1.5 times the national rate; (5) has a poverty rate of at least 20 percent for each populous census tract within the area; (6) has at least 70 percent of its households with incomes below 80 percent of the median income of households located within the jurisdiction of the local government, or had a population decrease of at least 20 percent between 1970 and 1980.

A nominated area that is a rural area¹⁶ would be eligible to be designated as an enterprise zone only if the area: (1) has a continu-

¹⁰ Subtitle B of Title III. S. 2217 was introduced (by request) on February 7, 1992, by Senators Dole and Domenici. This is the President's fiscal year 1993 budget proposal.

¹¹ Title VI. S. 1920 was introduced on November 6, 1991, by Senators Kasten, Wallop, Mack, Lott, Nickles, Symms, Smith, Burns, and Coats.

¹² Subtitle C of Title I. S. 1603 was introduced on July 31, 1991, by Senator Gramm.

¹³ S. 1032 was introduced on May 9, 1991, by Senators Danforth, Lieberman, Kasten, Grassley, McCain, Johnston, Bond, Garn, Mack, Cochran, Smith, Lott, Craig, McConnell, Gorton, Seymour, and D'Amato.

¹⁴ These bills also are substantially similar to the enterprise zone proposal included in the President's fiscal year 1993 budget proposals.

¹⁵ In the case of a nominated area on an Indian reservation, the reservation governing body would be deemed to be both the State and local government with respect to the area.

¹⁶ A rural area would be defined as an area that is (1) within a local government jurisdiction with a population of less than 50,000, (2) outside of a metropolitan statistical area, or (3) determined by the Secretary of HUD (after consultation with the Secretary of Commerce) to be a rural area.

ous boundary with a population of at least 1,000;¹⁷ (2) has pervasive poverty, unemployment and general distress; (3) is located within the jurisdiction of a local government that is eligible for Federal assistance under section 119 of the Housing and Community Development Act of 1974; and (4) meets at least one of the other criteria set forth above with respect to nonrural areas.

In addition, in order for any nominated area to be eligible to be designated as an enterprise zone, the local government and the State in which the area is located would be required to agree that they will follow a specified course of action that is designed to reduce the various burdens borne by employers or employees in the nominated area. A specified course of action would include (but would not be limited to) tax benefits, increases in the level of efficiency of local services within the area, involvement in the program by private job training and community groups, mechanisms to increase equity ownership by residents and employees within the area, donation of real estate to benefit low and moderate income people, provision of supporting public facilities and infrastructure improvements, and other financial incentives and assistance programs provided by State and local governments to encourage local entrepreneurship and improve the quality of life in the nominated area.

Under the bills, at least one-third of the areas designated as enterprise zones would be required to be rural areas. In addition, the Secretary would be required to designate enterprise zones from eligible nominated areas on the basis of the following selection criteria: (1) the strength and quality of promised contributions by State and local governments relative to their fiscal ability; (2) the effectiveness and enforceability of the course of action; (3) the level of commitment by private entities; (4) other factors, including relative distress, determined by the Secretary of HUD to be consistent with the intent of the enterprise zone program; and (5) reasonable geographic distribution of enterprise zones.

In general, the designation of an area as an enterprise zone would remain in effect for 25 years, unless the designation provides otherwise or the Secretary revokes the designation.

Tax incentives for enterprise zones

Refundable wage credit for low-income zone employees

The bills would provide a 5-percent refundable tax credit to enterprise zone employees for the first \$10,500 of wages¹⁸ paid to an employee. To qualify for the full credit, an employee must perform substantially all of his or her services within an enterprise zone for an enterprise zone business¹⁹ and have total wages below \$20,000. The maximum credit would be \$525; the credit would be phased out between \$20,000 and \$25,000 of total wages. In addition, the credit

¹⁷ There would be no population requirements if the zone is entirely within an Indian reservation.

¹⁸ For these purposes, "wages" generally would have the same meaning as for FUTA purposes.

¹⁹ An employee of the Federal Government or any State or local government would not qualify for the credit.

would be reduced for individuals subject to the alternative minimum tax.

In general, a business would qualify as an enterprise zone business if: (1) at least 80 percent of its gross income is attributable to active business activities conducted within the zone; (2) less than 10 percent of its property is stocks, securities or property held for use by customers; (3) no more than an insubstantial portion of the property is collectibles, unless held for sale to customers; (4) substantially all the property (whether owned or leased) is located within the zone; (5) substantially all the employees work within the zone; and (6) less than 50 percent (by value) of the business activity's property or services are obtained from, or provided to, related persons that are not enterprise zone businesses. Rental real estate located within an enterprise zone would be treated as an active business and could qualify as an enterprise zone business without regard to the 10-percent test described above.

Exclusion of enterprise zone capital gain

The bill would exclude from gross income certain long-term capital gain realized from the disposition of enterprise zone property. Enterprise zone property would be defined as real property and tangible personal property (other than financial property and collectibles) located in an enterprise zone and used in an enterprise zone business. To qualify for the exclusion, the property must have constituted enterprise zone property for at least two years prior to disposition.

Only those gains attributable to periods that the property was used in an enterprise zone business would be eligible for the exclusion. In addition, the gain exclusion would not apply to sales or exchanges of property between persons controlled by the same interests.

The gain exclusion would not be a preference for purposes of the alternative minimum tax.

Deduction for purchase of enterprise zone stock

Under the bills, individuals could elect to deduct up to \$50,000 per year of the purchase price of enterprise zone stock, subject to a \$250,000 lifetime limitation.²⁰ In order for stock to qualify as enterprise zone stock, the following requirements would have to be met: (1) the individual's purchase is on the original issue of the stock; (2) the amount of proceeds must be used by the issuer within 12 months to acquire (or maintain) newly acquired enterprise zone property; and (3) the issuer must be a subchapter C corporation (a) which does not have more than one class of stock, (b) which is engaged solely in the conduct of an enterprise zone business, (c) which does not own or lease more than \$5 million of property,²¹ and (d) more than 20 percent of whose stock is owned by individuals, partnerships, estates or trusts. In addition, a corporation could not issue more than \$5 million of enterprise zone stock.²²

²⁰ Under S. 1920, the limitation would be \$100,000 per year, subject to a \$500,000 lifetime cap.

²¹ Under S. 1920, the limitation would be \$50 million.

²² Under S. 1920, the limitation would be \$50 million.

If the stock is sold (or the stock or the corporation ceases to meet the qualifications discussed above), the gain (or the full deduction in the case of a disqualification) would be recaptured as ordinary income. In addition, if the stock is disposed of before being held for 5 years (or a disqualification occurs within 5 years of purchase of the enterprise zone stock), interest would be charged on the decrease in tax that resulted from the deduction. Under S. 2217, S. 1603, and S. 1032, the deduction would be treated as a preference for purposes of the alternative minimum tax.²³

Regulatory flexibility

The bills would expand the definition of a small entity, for purposes of the Regulatory Flexibility Act, to include any qualified enterprise zone business, any unit of government designating an area as an enterprise zone to the extent any regulatory rule would affect carrying out projects within the zone, and any not-for-profit enterprise operating within such a zone.

Establishment of foreign trade zones in enterprise zones

The bills would require the Foreign Trade Zone Board to consider on a priority basis the processing of any applications that involve the establishment of a foreign-trade zone in an enterprise zone. Similarly, the Secretary of the Treasury would be required to consider on a priority basis the processing of any application that involves the establishment of a port of entry that is necessary to permit the establishment of a foreign-trade zone in an enterprise zone. In evaluating applications for the establishment of foreign-trade zones and ports of entry in connection with enterprise zones, the Foreign Trade Zone Board and the Secretary of the Treasury would be required to approve the applications, to the maximum extent practicable, consistent with their respective statutory responsibilities.

Repeal of Title VII of the Housing and Community Development Act of 1987

The bills would repeal Title VII of the Housing and Community Development Act of 1987, effective upon enactment.

²³ In contrast, under S. 1920, the deduction would *not* be treated as a preference for purposes of the alternative minimum tax.

B. Description of Enterprise Zone Provisions of H.R. 4210 (Tax Fairness and Economic Growth Act of 1992) ²⁴

Designation of tax enterprise zones

In general

Under H.R. 4210, 35 tax enterprise zones would be designated during the period 1993 through 1995. Tax enterprise zones would be either urban tax enterprise zones or rural development investment zones. The Secretary of Housing and Urban Development would designate 10 areas as urban tax enterprise zones. The Secretary of Agriculture (in consultation with the Secretary of Commerce) would designate 25 areas as rural development investment zones.²⁵ All designated areas would be selected from areas nominated by State and local governments, a State-chartered economic development corporation (or similar entity), or the governing body of an Indian reservation. Designation of an area as a tax enterprise zone generally would remain in effect for 15 years.

Eligibility criteria for urban tax enterprise zones

To be eligible for designation as an urban tax enterprise zone, a nominated area would be required to have all of the following characteristics: (1) a population of at least 4,000; (2) a condition of pervasive poverty, unemployment, and general economic distress, which may include the distress resulting from a high incidence of crime and narcotics use; (3) with respect to size, (a) does not exceed 12 square miles, (b) consists of not more than three noncontiguous parcels, and (c) is located entirely within one State; (4) an unemployment rate of at least 1.5 times the national unemployment rate; (5) poverty rates of at least 20 percent in each of 90 percent of the area's census tracts; and (6) a satisfactory course of action (described below) adopted by the State or local governments for the nominated area designed to promote economic development in the zone.

Eligibility criteria for rural development investment zones

To be nominated as a rural development investment zone, an area would be required to be either outside a standard metropolitan statistical area or determined by the Secretary of Agriculture (in consultation with the Secretary of Commerce) to be a rural area. To be eligible for designation, a nominated rural area is required to possess the following four characteristics: (1) a population of at least 1,000; (2) a condition of general economic distress; (3) with respect to size, (a) does not exceed 10,000 square miles, (b) is located within not more than four contiguous counties, (c) consists of not more than three noncontiguous parcels, and (d) is located entirely within one State;²⁶ and (4) a satisfactory course of action

²⁴ H.R. 4210, as reported by the committee of conference (H. Rept. 102-461), was passed by the House of Representatives and the Senate on March 20, 1992, but was vetoed by the President on that date.

²⁵ The Secretary of Agriculture would be required to designate at least one rural development investment zone located on an Indian reservation.

²⁶ In the case of a nominated area which is located on one or more Indian reservations, the nominated area need not be located entirely within one State.

(described below) adopted by State or local governments for the nominated area. In addition, a rural area is required to meet at least two of the following four requirements: (1) an unemployment rate of at least 1.5 times the national unemployment rate; (2) poverty rates of at least 20 percent in each of 90 percent of the area's census tracts; (3) a decline in employment (as measured by total wages) of more than five percent over the five-year period prior to the zone's designation; and (4) a decline in population of 10 percent or more over the period from 1980 to 1990.

Course of action

In order for any nominated area to be eligible to be designated as a tax enterprise zone, the local government and State in which the area is located would be required to agree in writing that they will follow a specified course of action designed to reduce burdens borne by employers or employees in the area. A specified course of action could include one or more of the following actions with respect to a nominated area: reduced tax rates or fees; increased delivery of local public services; simplified government paperwork requirements; involvement in the program by public or private entities (e.g., community groups), including a commitment to provide jobs and job training, and technical, financial, or other assistance to employers, employees, and residents of the area; special preferences granted to minority contractors; donations of surplus land to community organizations agreeing to operate businesses on the land; programs to encourage employers to purchase health insurance for employees on a pooled basis; certain programs to encourage local financial institutions to make loans to area businesses (with emphasis on start-up firms and other small businesses); and special preferences for projects within the area in allocations of the State's low-income housing credit ceiling and private activity bonds ceiling. Programs which serve as part of the required course of action with respect to a nominated zone could not be funded from proceeds from any Federal program.²⁷

Selection process and criteria

The Secretary of Housing and Urban Development would designate a total of ten urban tax enterprise zones, consisting of five urban zones designated in 1993, three in 1994, and two in 1995. The Secretary of Agriculture (in consultation with the Secretary of Commerce) would designate a total of 25 rural development investment zones, consisting of 12 rural zones designated in 1993, seven in 1994, and six in 1995.²⁸

²⁷ In addition, the course of action implemented generally could not include any action to assist any business establishment in relocating into the zone from another area. However, this limitation would not be construed to prohibit assistance for the expansion of an existing business if the Secretary of Housing and Urban Development (in the case of an urban tax enterprise zone) or Secretary of Agriculture (in the case of a rural development investment zone) finds that establishment of a new branch or subsidiary will not increase unemployment in an area where the existing business conducts business operations and that there is no reason to believe that the new branch or subsidiary is being established with the intention of closing down the operations of the existing business in other locations.

²⁸ For both urban tax enterprise zones and rural development investment zones, any shortfall in designations below the annual maximum for 1993 and 1994 could be carried forward by the respective Secretaries, but could not be carried beyond 1995.

A designation made during any calendar year would be treated as made on January 1 of the following calendar year if so provided in the designation.

All designated tax enterprise zones would be selected from nominated areas on the basis of the following criteria (each of which would be given equal weight): (1) the strength and quality of promised contributions by State and local governments relative to their fiscal ability; (2) the effectiveness and enforceability of the guarantees that the promised course of action actually will be implemented; (3) the level of commitments by private entities of additional resources to the economy of the nominated area, including the creation of new or expanded business activities; (4) the average ranking (relative to other nominated areas) with respect to (a) in the case of a nominated urban tax enterprise zone, the degree of poverty and unemployment, or (b) in the case of a nominated rural development investment zone, two of the following criteria that give the area a higher average ranking: poverty, unemployment, job loss, or population loss; and (5) the potential for revitalization of the nominated area (including the potential reduction in the incidence of crime and narcotics use and traffic), taking into account particularly the number of jobs to be created and retained.

Period designation in effect

Designation of an area as a tax enterprise zone generally would remain in effect for a period of 15 years. However, an area's designation as a tax enterprise zone would be revoked if it is determined (after a hearing on the record) by the Secretary of Housing and Urban Development (in the case of an urban tax enterprise zone) or the Secretary of Agriculture (in the case of a rural development investment zone) that the local government or State in which the area is located has significantly modified the boundaries of the zone or is not complying substantially with commitments made as part of the required course of action.

Tax incentives for enterprise zones

Employer wage credit

A 7.5-percent nonrefundable tax credit would be provided to certain small employers for qualified enterprise zone wages. Qualified enterprise zone wages would be defined as wages paid to an individual who (1) does not receive annual wages or salary exceeding \$30,000, (2) resides in the tax enterprise zone, and (3) performs substantially all services for the employer trade or business within the tax enterprise zone. However, wages would not be eligible for the credit if paid to certain relatives of the employer or, if the employer is a corporation, certain relatives of a person who owns more than 50 percent of the corporation. In addition, wages would not be eligible for the credit if paid to a person who owns more than five percent of the stock of the employer (or if the employer is not a corporation, more than five percent of the capital or profits interest in the employer).²⁹

For purposes of this credit, a "small employer" would be defined as an employer that, on average, did not employ more than 100

²⁹ In addition, wages would not be eligible for the credit if attributable to services rendered by an employee during the first year he or she begins employment if any portion of such wages are qualified wages for purposes of the targeted jobs tax credit (sec. 51).

full-time employees during the taxable year.³⁰ If an employee is terminated less than one year after initial employment, the amount of credits previously claimed by the employer with respect to that employee generally would be recaptured.³¹

The wage credit would not be available for wages or salary paid to an employee beyond five years after the date such employee first began work for the employer (whether or not in a tax enterprise zone). The total wage credit that could be claimed by any small employer for any taxable year cannot exceed the credit amount allocated to that employer by the tax enterprise zone allocating official (whose functions are described below). The employer's deductions for wages or salaries paid would be reduced by the amount of credit determined for the taxable year. For alternative minimum tax (AMT) purposes, the wage credit would not be allowed to offset tentative minimum tax.³²

Deduction for purchase of enterprise zone stock

An individual would be allowed an itemized deduction for the amount paid in cash during any taxable year to purchase enterprise zone stock. The amount allowed as a deduction for any taxable year would be limited to the lesser of (1) \$25,000, or (2) the enterprise zone stock amount allocated to the taxpayer for the taxable year by the tax enterprise zone allocating official (whose functions are described below). If the amount paid in cash during any taxable year to purchase enterprise zone stock exceeds the limitation for such year, then the excess amount would be treated as paid for such stock during the immediately succeeding taxable year. In no event, however, would the amount of the deduction allowed under the provision with respect to any one individual to exceed \$250,000.³³ In addition, the maximum amount of enterprise zone stock that may be issued by any corporation would be limited to \$5 million.

Enterprise zone stock would be defined as stock of a C corporation which is acquired on original issue from a corporation that is a qualified issuer, but only to the extent that the cash paid for the stock is used by the corporation within a 12-month period to acquire qualified enterprise zone property. A qualified issuer would be defined as a domestic C corporation that satisfies the following requirements: (1) the corporation does not have more than one class of stock outstanding; (2) the sum of (a) the unadjusted bases of the assets owned by the corporation and (b) the value (as determined under Treasury regulations) of the assets leased by the corporation does not exceed \$5 million; (3) more than 20 percent of the total value and total voting power of the stock of the corporation is

³⁰ For purposes of the credit, certain related employers that are considered to be part of a controlled group under section 52(a) or (b) would be treated as a single employer.

³¹ However, this rule would not apply if the employee voluntarily leaves the employment, becomes disabled to perform the services of such employment (unless the disability is removed before the close of the one-year period and the employer fails to offer reemployment), or if it is determined under applicable State unemployment compensation law that the termination was due to misconduct by the employee.

³² The wage credit would be a general business credit subject to the limitations of section 38.

³³ For purposes of the \$25,000 annual limitation and the \$250,000 lifetime limitation, an individual and all members of his or her family (as defined in section 267(c)(4)) would be treated as a single individual.

owned by individuals (directly or through partnerships or trusts) or by estates; and (4) the corporation satisfies the enterprise zone business requirements.

A corporation would satisfy the enterprise zone business requirements for any taxable year if: (1) at least 80 percent of the gross income of the corporation for the taxable year is derived from the active conduct of a trade or business within a tax enterprise zone; (2) substantially all of the use of the tangible property of the corporation (whether owned by the corporation or leased by the corporation) during the taxable year occurs within a tax enterprise zone; (3) substantially all of the services performed for the corporation by employees of the corporation during the taxable year are performed in a tax enterprise zone; (4) less than 10 percent of the average of the aggregate unadjusted bases of the property owned by the corporation during the taxable year is attributable to securities (as defined in section 165(g)(2)); and (5) no more than an insubstantial portion of the property owned by the corporation during the taxable year constitutes collectibles that are not held primarily for sale to customers in the ordinary course of an active trade or business.

For purposes of determining whether a corporation satisfies these requirements, leasing real property that is located within a tax enterprise zone to (or otherwise holding real property for use by) persons that are not related to the corporation would be treated as the active conduct of a trade or business. In addition, a corporation would be treated as failing to satisfy the enterprise zone business requirements for any taxable year if either: (1) more than 50 percent of the property or services acquired by the corporation during any taxable year is acquired from persons that are related to the corporation and that are not qualified issuers; or (2) more than 50 percent of the gross income of the corporation for the taxable year is derived from property or services provided to certain persons that are related to the corporation and that are not qualified issuers.

Qualified enterprise zone property would be defined as tangible property (whether real or personal) to which section 168 of the Code applies, but only if the original use of the property commences with the qualified issuer and substantially all of the use of the property is in the tax enterprise zone.

Special "recapture" rules would apply if, at any time after the acquisition of the enterprise zone stock, the stock is disposed of, or, if, at any time during the 10-year period beginning on the date of the acquisition of the enterprise zone stock, either (1) the issuer of the enterprise zone stock ceases to satisfy the definition of a qualified issuer;³⁴ or (2) the amount paid for the enterprise zone stock ceases to be invested by the qualified issuer in qualified enterprise zone property. First, the amount realized on the disposition of the enterprise zone stock would be required to be recognized notwith-

³⁴ The determination of whether a corporation ceases to satisfy the definition of a qualified issuer would be made without regard to the requirement that the sum of (1) the unadjusted bases of the assets owned by the corporation and (2) the value (as determined under Treasury regulations) of the assets leased by the corporation does not exceed \$5 million. In addition, a corporation would not be treated as ceasing to satisfy the definition of a qualified issuer solely by reason of a termination or a revocation of a tax enterprise zone designation.

standing any other provision of the Code and would be treated as ordinary income to the extent that the amount realized does not exceed the amount allowed as a deduction. Second, if enterprise zone stock is disposed of within five years after the date of acquisition of the stock, the taxpayer would be required to pay interest on the amount of tax that would otherwise have been due if a deduction had not been allowed for the purchase of the enterprise zone stock.

The basis of enterprise zone stock would be reduced by the amount of the deduction allowed under this provision. In addition, the deduction for the purchase of enterprise stock would be an adjustment that is required to be taken into account by individuals in computing alternative minimum taxable income (i.e., the deduction would be added to taxable income in determining alternative minimum taxable income).

Additional first-year depreciation allowance

An additional depreciation allowance equal to 25 percent of the adjusted basis of certain qualified zone property would be allowed for the taxable year that the property is placed in service. The additional depreciation, however, would be allowed only with respect to the adjusted basis of qualified zone property for which the taxpayer has received an additional first-year depreciation allowance from the tax enterprise zone allocating official (whose functions are described below). In addition, the adjusted basis of any qualified zone property with respect to which the additional first-year depreciation allowance is allowed would be reduced by the amount of such allowance before computing the amount otherwise allowable as a depreciation deduction with respect to the property for the taxable year that the property is placed in service and for any subsequent taxable year.

For this purpose, qualified zone property would be defined as any tangible property to which section 168 of the Code applies (other than property that is required to be taken into account under the alternative depreciation system of section 168(g)) but only if: (1) the property is section 1245 property (generally tangible personal property and certain real property other than buildings and structural components of buildings); (2) the original use of the property commences with the taxpayer in a tax enterprise zone; and (3) substantially all of the use of the property is in a tax enterprise zone and in the active conduct of a trade or business by the taxpayer in a tax enterprise zone.

The additional depreciation allowance would be taken into account for regular tax purposes and for purposes of the alternative minimum tax (i.e., it would not be a preference for AMT purposes).

Overall limitation on zone tax incentives

In general

Each tax enterprise zone would be subject to an annual overall limitation on the amount of tax incentives that can be provided with respect to that zone. Urban tax enterprise zones generally would have an annual limitation of \$13 million, and rural development investment zones generally would have an annual limitation

of \$5 million. However, this annual limitation would be increased with respect to a zone by up to an additional 10 percent (i.e., an additional \$1.3 million for an urban tax enterprise zone, and an additional \$.5 million for a rural development investment zone) if certain expenditures are made to promote development in the zone (e.g., for public improvements or additional police protection) and certain incentives are provided (e.g., property or sales tax abatements) by the local governments and State in which the zone is located.

Allocation of tax incentives

With respect to each tax enterprise zone, the local governments and the State in which the zone is located would be required to designate a government official (the "allocating official") with responsibility for making allocations of employment wage credits, deductible enterprise zone stock amounts, and additional first-year depreciation allowance amounts. Enterprise zone tax incentives would be available to a taxpayer only if the allocating official provides a specific allocation to that taxpayer. For instance, a wage credit could be claimed by a small employer only up to the amount for which that employer has received an allocation for that taxable year. Similarly, the allocating official would be required to specify the particular stock purchases for which the deduction provided for by the bill may be claimed, as well as the specific property for which the additional first-year depreciation allowance may be claimed.

The allocating official for each tax enterprise zone could make total allocations for each calendar year up to an amount which corresponds with the overall zone limitation on tax incentives for that year. Total allocations made in a year could be for one or more of the three tax incentives provided in the bill, depending on the combination of incentives determined by the allocating official to be appropriate for the particular enterprise zone during that year. To the extent the allocating official allocates less than the total amount of allowable tax incentives for any year, unused allocations could be carried forward to the following year (except that total unused allocations carried forward from previous years may not exceed 70 percent of the otherwise applicable zone limitation). Allocations of tax incentives made by the allocating official would be counted towards the annual overall zone limitation in the following manner: for each allocated dollar of employment wage credit, the zone limitation would be reduced by 67 cents; for each allocated dollar of deduction for enterprise zone stock, the zone limitation would be reduced by 35 cents; and for each allocated dollar of adjusted basis of property with respect to which the additional first-year depreciation is allowed, the zone limitation would be reduced by 1.5 cents.³⁵

Studies

The Secretary of the Treasury and Comptroller General each would be directed to submit an interim report by July 1, 1996, and

³⁵ These amounts by which the overall zone limitation would be reduced were designed to represent the approximate revenue cost of each of the enterprise zone tax incentives provided for by the bill.

a final report by July 1, 2001, to the House Committee on Ways and Means and the Senate Committee on Finance, analyzing the effectiveness of the tax enterprise zones.

Effective date

A Tax enterprise zone designations could be made only during calendar years 1993 through 1995. Designations generally would remain in effect for 15 years.

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C. Other Proposals

Among other proposals to promote the economic development of certain geographic areas, S. 686 and S. 383 would establish enterprise zones in certain rural areas and Indian reservations.

1. Description of S. 686 (Rural Business Revitalization Act of 1991)³⁶

Designation of rural enterprise zones

The Secretary of the Treasury (after consultation with the Secretary of Agriculture, Secretary of Commerce, Secretary of Labor, and the Administrator of the Small Business Administration) would be authorized to designate an area as a rural enterprise zone if such area was nominated as such by one or more local governments and the State in which the area was located.³⁷ The bill would not impose a limit on the number of areas that could be designated as rural enterprise zones. Zone designations generally would be effective for 15 years.

A nominated area would be eligible to be designated as a rural enterprise zone only if the area met the following requirements: (1) the area is a county or political subdivision with an aggregate population of 50,000 or less (or the Secretary of the Treasury determines that the area is a rural area); (2) the boundary of the area is continuous; and (3) general economic distress exists within the area as shown by at least one of the following factors: (a) evidence of high rates of poverty or unemployment, reduced incomes, or the number of jobs in the area has dropped from year-to-year; (b) the area is located within the jurisdiction of a local government that the Secretary of the Treasury finds is experiencing a high number of farm or small business bankruptcies, loss of private investment in the business sector, or other factors determined to be relevant in assessing the comparative degree of economic deterioration in the rural area; or (c) during the period after 1974 and before nomination, there are five years during which the population of the area (as determined from the most recent Department of Commerce estimates) decreased by at least two percent from the prior year.

An area could not be designated as a rural enterprise zone unless the local government and the State in which it was located agreed that, during any period that the area was a rural enterprise zone, they would follow a specified course of action designed to reduce the various burdens borne by employers or employees in the area.

This course of action could be implemented by the State and local governments and private nongovernmental entities, and could be funded from the proceeds of any Federal program. The course of action could include, but would not be limited to: (1) a reduction of tax rates or fees applying within the area; (2) an increase in the level or efficiency of local services within the area; (3) elimination, reduction, or simplification of governmental requirements applying within the area; (4) program involvement by private entities, organizations, neighborhood associations and community groups, par-

³⁶ S. 686 was introduced by Senator Baucus on March 19, 1991.

³⁷ In the case of a nominated area on an Indian reservation, the reservation governing body would be deemed to be both the State and local governments with respect to the area.

ticularly those within the nominated area (including a commitment from these private entities to provide technical, financial or other assistance to, and jobs or job training for, employers, employees and residents of the area); and (5) mechanisms to increase the equity ownership of residents and employees within the rural enterprise zone.

Tax incentives for rural enterprise zones

Employer wage tax credit

The bill would provide a 10-percent tax credit to employers in rural enterprise zones for certain wages paid to qualified employees who perform at least 50 percent of their services for the employer during the taxable year in a zone. The 10-percent credit would apply to (1) the amount of qualified wages paid by an employer in a rural enterprise zone during a taxable year that exceeds the qualified wages paid (with certain inflation adjustments) during the 12-month period that preceded the date on which the zone was designated, and (2) wages paid employees during any portion of the taxable year during which the employer is training or retraining such employees. Qualified wages for purposes of this credit generally would follow the definition of wages currently applicable for FUTA tax purposes, with certain adjustments. One such modification would be the exclusion from the wage base of any Federally funded payments the employer received or accrued for on-the-job training. Special rules also would be provided for agricultural and railway labor.

A taxpayer's deduction otherwise allowed for wages paid would be reduced by the amount of wage credit allowable for the taxable year. In addition, the credit would be subject to the present-law general business credit limitations of section 38.

Investment tax credit

S. 686 would provide a 10-percent credit for the taxpayer's basis in zone personal property and new zone construction property acquired and first placed in service during a taxable year in which the area qualifies as a rural enterprise zone. For purposes of this credit, zone personal property would include property used or located in an active trade or business within a rural enterprise zone, and which is either three-year, five-year, seven-year, 10-year, 15-year, or 20-year property under section 168(e). New zone construction property would consist of depreciable real property located in a rural enterprise zone and used by the taxpayer predominantly in the active conduct of a trade or business within the zone. If acquired by the taxpayer, the first use of the property must commence with the taxpayer during the period the area is a rural enterprise zone. Otherwise the construction, reconstruction, or rehabilitation of the property by the taxpayer must be completed during the period that the area is a rural enterprise zone. For purposes of this credit, the ownership of rental real estate would constitute an active trade or business.

Increase in research credit for research conducted in rural enterprise zones

The bill would provide a 40-percent credit rate (in lieu of the present-law 20-percent credit rate)³⁸ for qualified research expenditures that exceed a taxpayer's base amount with respect to research conducted in a rural enterprise zone.

Deferral of capital gain reinvested in zone property

The bill would allow taxpayers to defer the recognition of long-term capital gain from the sale or exchange of any property up to nine taxable years after the year in which the sale or exchange occurs if the amount realized from the sale or exchange is used to purchase qualified zone property within two years after the close of the taxable year of the sale or exchange.

For this purpose, qualified zone property would be defined as (1) any tangible property if substantially all of the use of such property occurs in a rural enterprise zone and in the active conduct of a trade or business by the taxpayer in the zone, (2) certain depreciable real property located in a zone and used in an active trade or business, and (3) any stock in a corporation or a partnership interest if two conditions are satisfied. First, at the time that the stock or partnership interest is issued, substantially all of the activities of the corporation or partnership must involve (or, in the case of a new corporation or partnership, will involve) the active conduct of one or more trades or businesses in a rural enterprise zone. Second, the stock or partnership interest must be issued by the corporation or partnership for money or other property (other than stock or securities).

If a taxpayer disposes of qualified zone property (or the property otherwise ceases to be qualified zone property) before five years after the date that the property is purchased, then (1) the amount of gain that was deferred under this provision would be taken into account for the taxable year in which the disposition (or cessation) occurs, and (2) interest would be payable by the taxpayer on the amount of deferred tax for the period of deferral.

The capital gain deferral would not be a preference for purposes of the alternative minimum tax.

³⁸ The present-law research tax credit currently is scheduled to expire after June 30, 1992 (sec. 41(h)).

2. Description of S. 383 (Indian Economic Development Act of 1991)³⁹

Designation of Indian enterprise zones

Under S. 383, the Secretary of Housing and Urban Development would be authorized to designate up to 12 Indian enterprise zones between 1992 and 1995. No more than five Indian enterprise zones could be designated in 1992 and no more than nine Indian enterprise zones could be designated in 1993. All designated areas would be selected from areas nominated by the governing body of Indian tribes. Designation of an area as an Indian enterprise zone generally would be effective for 25 years.

To be eligible for designation as an Indian enterprise zone, a nominated area would be required to have all of the following characteristics: (1) a population of at least 75 Indian residents; (2) a condition of widespread poverty, unemployment, and general distress; (3) with respect to size, the area (a) does not exceed 200 square miles, (b) consists of not more than five noncontiguous parcels, (c) is accessible to a labor force of Indian employees, and (d) is located entirely within one Indian reservation; (4) an unemployment rate for the reservation within which the area is located of at least 1.5 times the national unemployment rate; and (5) a poverty rate for the reservation within which the area is located of at least 20 percent.

The Secretary of Housing and Urban Development would select among nominated areas on the basis of specific selection criteria including: (1) the willingness of the tribal government to make efforts to attract business to the zone; (2) the level of private enterprise commitment; (3) the effectiveness and enforceability of tribal commitments; and (4) the economic and social conditions and potential for the nominated zone.

Tax incentives for Indian enterprise zones

Employer wage credit

The bill would provide a 10-percent income tax credit to employers in Indian enterprise zones for wages paid to qualified zone employees and for certain health insurance costs paid or incurred with respect to qualified zone employees.⁴⁰ A qualified zone employee would be defined as an employee who (1) receives annual wages from the employer of \$30,000 or less, (2) resides on or near the reservation within which the Indian enterprise zone is located, and (3) performs substantially all services for the employer trade or business within the Indian enterprise zone.

The wage credit would not be available for wages paid to an employee beyond seven years after the date such employee first began work for the employer (whether or not in an Indian enterprise zone). The total wage credit that is claimed by any employer for any taxable year could not exceed the employment credit amount allocated to that employer for the taxable year by the Indian enter-

³⁹ S. 383 was introduced on February 6, 1991, by Senators McCain, Inouye, Domenici, Burdick, Gorton, Simon, Murkowski, Cochran, and Conrad.

⁴⁰ The credit rate would be 25 percent in the case of an employer with at least 60 percent Indian employees.

prise zone allocating official (whose functions are described below). The employer's deductions for wages would be reduced by the amount of credit determined for the taxable year. For alternative minimum tax (AMT) purposes, the wage credit would not be allowed to offset tentative minimum tax.⁴¹

Deferral of capital gain reinvested in zone property

The bill would allow taxpayers to defer the recognition of long-term capital gain from the sale or exchange of any property up to nine taxable years after the year in which the sale or exchange occurs if the amount realized from the sale or exchange is used to purchase qualified zone property within two years after the close of the taxable year of the sale or exchange. The amount of gain that is deferred for any taxable year could not exceed the capital gain deferral amount allocated to the taxpayer for the taxable year by the Indian enterprise zone allocating official (whose functions are described below).

For this purpose, qualified zone property would be defined as (1) any tangible property if substantially all of the use of such property occurs in an Indian enterprise zone and in the active conduct of a trade or business by the taxpayer in the zone and (2) any stock in a corporation or a partnership interest if two conditions are satisfied. First, at the time that the stock or partnership interest is issued, substantially all of the activities of the corporation or partnership must involve (or, in the case of a new corporation or partnership, will involve) the active conduct of one or more trades or businesses in an Indian enterprise zone. Second, the stock or partnership interest must be issued by the corporation or partnership for money or other property (other than stock or securities).

If a taxpayer disposes of qualified zone property (or the property otherwise ceases to be qualified zone property) before five years after the date that the property is purchased, then (1) the amount of gain that was deferred under this provision would be taken into account for the taxable year in which the disposition (or cessation) occurs, and (2) interest would be payable by the taxpayer on the amount of deferred tax for the period of deferral.

The capital gain deferral would be a preference for purposes of the alternative minimum tax.

Child care facility credit

The bill would provide an income tax credit equal to 25 percent of the cost of acquiring, constructing, or rehabilitating a child care facility that is (1) located in an Indian enterprise zone, (2) operated by a taxpayer for the care of enrollees who reside in the zone, and (3) licensed or accredited to operate as a child care facility. The amount of costs taken into account in determining the credit would be limited to \$400,000 per taxpayer. In addition, the amount of the credit for any taxable year could not exceed the child care facility credit amount allocated to the taxpayer for the taxable year by the Indian enterprise zone allocating official (whose functions are described below).

⁴¹ The wage credit would be a general business credit subject to the limitations of section 38.

The credit would be recaptured upon the occurrence of certain events. In addition, the basis of any property with respect to which the credit is allowed would be reduced by the full amount of the credit. The credit would be a general business credit and, as such, would not be allowed to offset tentative minimum tax.

Tax payment credit

The bill would provide an income tax credit equal to the lesser of (1) the portion of the income tax of any taxpayer that is attributable to 50 percent of the taxable income that is derived from the active conduct of a trade or business in an Indian enterprise zone, or (2) \$8,000 multiplied by the number of full-time Indian employees of such trade or business. The amount of the credit for any taxable year could not exceed the tax payment credit amount allocated to the taxpayer for the taxable year by the Indian enterprise zone allocating official (whose functions are described below). The credit would not be allowed to offset tentative minimum tax.

Overall limitation on zone tax incentives

Each Indian enterprise zone would be subject to an annual limitation on the amount of tax incentives that could be provided with respect to that zone. The annual limitation would equal \$10 million plus an amount that is based on the population of the reservation within which the Indian enterprise zone is located.⁴² In addition, the limitation may be increased by up to an additional 10 percent (i.e., an additional \$1 million) if certain expenditures are made to promote development in the zone (e.g., for public improvements or additional police protection) and certain incentives are provided (e.g., property or sales tax abatements) by the tribal government, local government, or State in which the zone is located.

With respect to each Indian enterprise zone, the tribal government would be required to designate a government official (the "allocating official") with responsibility for making allocations of employment credit amounts, capital gain deferral amounts, child care facility credit amounts, and tax payment credit amounts. Enterprise zone tax incentives would be available to a taxpayer only if the allocating official provides a specific allocation to that taxpayer. The allocating official for each tax enterprise zone could make total allocations for each calendar year up to an amount which corresponds with the overall zone limitation on tax incentives for that year.

Other tax provision

The bill would permanently extend the authority to issue qualified small issue bonds for Indian enterprise zones.

Other non-tax provisions

The bill would require the Foreign Trade Zone Board to consider on a priority basis the processing of any applications that involve

⁴² The additional amount generally would equal \$50 million multiplied by a ratio, the numerator of which is the population of the reservation within which the zone is located and the denominator of which is the population of all reservations containing Indian enterprise zones designated during the calendar year.

the establishment of a foreign-trade zone in an Indian enterprise zone. Similarly, the Secretary of the Treasury would be required to consider on a priority basis the processing of any application that involves the establishment of a port of entry that is necessary to permit the establishment of a foreign-trade zone in an Indian enterprise zone. In evaluating applications for the establishment of foreign-trade zones and ports of entry in connection with Indian enterprise zones, the Foreign Trade Zone Board and the Secretary of the Treasury would be required to approve the applications, to the maximum extent practicable, consistent with their respective statutory responsibilities.

The bill would also require the Secretary of the Treasury and the Comptroller General to submit a report to the House Committee on Ways and Means and the Senate Committee on Finance not later than July 1, 1995, on the overall impact of the bill.

IV. ISSUES RELATING TO TAX INCENTIVES FOR ENTERPRISE ZONES

A. Overview of Issues

As a geographic matter, economic growth and development have not occurred evenly across the United States. While differences in resources and climates may explain part of the geographic diversity, within States and cities the pattern of economic growth is uneven. Some areas have high unemployment and decaying structures, while nearby areas enjoy full employment and economic growth. Some analysts have argued that this uneven pattern of growth is evidence of a failure of the market and that government intervention may be appropriate to encourage a more geographically even pattern of growth. In addition, other analysts observe that areas of high unemployment and blight often are characterized by higher crime rates, poorer health of residents, and other social ills. They note these problems represent additional costs to society at large and that efforts to aid economic development in such areas would improve social welfare beyond that which would be measured by job creation, wages, or output.

Enterprise zone tax incentives are intended to encourage economic activity within a particular geographic location. Almost all enterprise zone proposals provide tax incentives for the location of certain activities within certain economically distressed areas.⁴³ The proposals differ with respect to economic activities that are provided tax incentives and the manner in which the incentives are provided. For example, enterprise zone proposals may provide incentives for certain types of employment through an employer or an employee wage credit, or for certain types of capital investment through accelerated capital recovery methods or capital gains tax relief. In addition, the proposals often target relief to small businesses. Therefore, not only do enterprise zone proposals target tax incentives to particular geographic locations, but also within each enterprise zone the proposals direct tax incentives to particular types of activities.

⁴³ In many respects, the tax treatment of certain businesses located in U.S. possessions is analogous to tax provisions of enterprise zone proposals. The Puerto Rico and possessions tax credit shelters from U.S. income tax business income and qualified passive investment income earned by certain U.S. corporations operating in U.S. possessions ("section 936 corporations"). Almost all section 936 corporations operate in Puerto Rico. The Finance Committee Report accompanying the 1976 Tax Reform Act states that the purpose for the special tax status accorded possession-source income is "[to] assist the U.S. possessions in obtaining employment producing investment by U.S. corporations." Like enterprise zone proposals, section 936 provides tax incentives to encourage the location of economic activities within a limited geographic area exhibiting economic distress. See, for example, Ramon E. Daubon and Jose J. Villamil, "Puerto Rico as an Enterprise Zone," in Roy E. Green, editor, *Enterprise Zones: New Directions in Economic Development*, (London: Sage Publications), 1990.

Possible goals of geographic tax incentives

Enterprise zone proposals intend to provide economic aid to distressed areas. However, the aid may be intended to achieve several distinct and perhaps disparate goals. One goal may be to rebuild a blighted urban area. Another goal may be to attract business activity to the area. Yet, another goal may be to increase the employment opportunity and incomes earned by those people who currently live in the designated area.

Policies designed to address one goal, if not carefully crafted, may work against the attainment of another goal. For example, gentrification⁴⁴ of a blighted urban neighborhood may rebuild the area, but it may provide no jobs or increase in income to those who were area residents prior to gentrification. The increase in property values which accompanies gentrification may further impoverish those who were area residents prior to the gentrification or force them to move to other areas. A policy that successfully attracts businesses to a particular geographic location may return some economic vitality to that area. However, if the businesses utilize labor skills not possessed by residents of the area, there may be few gains in income to those residents. Similarly, a business may be attracted to an area to utilize the base of low skilled, low wage labor. While such businesses provide employment opportunities, they may not promote significant income growth for area residents. Without income growth there may not be significant rebuilding of the area's physical structure. As a further example, siting a business within a specific geographic area may result in the displacement of current residents from that area. Alternatively, a policy which successfully promotes income growth of residents of an area may enable those residents to choose to leave the area which may result in further blight.

The effect of tax incentives on the location of investments

Enterprise zone proposals contemplate that economic incentives provided through Federal income tax relief can redirect investment toward economically disadvantaged areas. In theory, the provision of financial incentives should be able to induce economic activity to be located in designated areas. However, empirical research is inconclusive and, in any event, even if investment is redirected, cost benefit analysis might show that society does not benefit from the relocation of investment. As there are few Federal programs that provide economic incentives to redirect investment geographically, most existing studies are based on State and local initiatives and the British experience. The State and local initiatives may not be relevant to analysis of a Federal program, if it is contemplated that the Federal program will offer larger economic incentives than do existing State and local initiatives. Moreover the types of tax incentives offered may be fundamentally different. For example, sales and property tax exemptions have no direct Federal counterpart. Similarly, the British experience may not be relevant to proposals for the United States.

⁴⁴ Gentrification generally refers to the immigration of middle and upper income individuals into a deteriorating or recently renewed area.

Research on the impact of State and local tax factors on the location decisions of firms is inconclusive. On the one hand, lower local property taxes or lower State or local income taxes act directly to lower the cost of doing business in a particular area. This could make low tax jurisdictions relatively attractive to businesses. On the other hand, relatively high tax jurisdictions may provide more and higher quality public services and are often associated with highly educated and/or highly skilled local labor forces. These factors could offset the higher tax cost of doing business in a high tax jurisdiction. Separating these conflicting forces is a difficult task and conclusive econometric evidence has not yet been provided on this issue.⁴⁵

The General Accounting Office (GAO) has attempted to measure empirically the employment changes resulting from the tax benefits provided under one State's enterprise zone program.⁴⁶ The GAO measured monthly employment changes in three enterprise zones over a four-year period and concluded that while increases in employment did occur, "factors other than the [enterprise zone] program seemed to account for these increases."⁴⁷ The empirical analysis of the GAO study has been criticized.⁴⁸ For example, it is difficult to specify a correct counter-factual hypothesis of what employment levels would have been in the absence of the enterprise zone program. This makes it difficult to determine which, if any, changes in employment result from enterprise zone benefits. Also, four years may be too short a time period to assess the economic effect of an enterprise zone program.⁴⁹

Another study has taken a broader approach by attempting to empirically account for the sources of employment growth in 37 disaggregated sectors across United States metropolitan areas over the period 1977 to 1984.⁵⁰ The authors found that the presence of enterprise zones was positively related to employment growth in some sectors, specifically, total manufacturing, hospitals, legal serv-

⁴⁵ For examples on both sides of the issue, see Dennis Carlton, "Why New Firms Locate Where They Do: An Econometric Model", in *Interregional Movements and Regional Growth* (William Wheaton, ed.), Urban Institute, 1979; Leslie E. Papke, "Interstate Business Tax Differentials and New Firm Location: Evidence from Panel Data," *Journal of Public Economics*, 45, June 1991; Breandon O hUallachain and Mark A. Satterthwaite, "Sectorial Growth Patterns at the Metropolitan Level: An Evaluation of Economic Development Incentives," photocopy, Department of Geography, Arizona State University and Kellogg Graduate School of Management, Northwestern University, August 22, 1989; and Robert Newman and Dennis Sullivan, "Econometric Analysis of Business Tax Impacts on Industrial Location: What Do We Know and How Do We Know It?", *Journal of Urban Economics*, March 1988.

It is important to note that empirical studies of location decisions also investigate other factors besides taxes. For example, one study concludes that generally lower taxes and higher levels of public services influence firm location decisions. See, Timothy J. Bartik, *Who Benefits from State and Local Economic Development Policies?* (Kalamazoo, Michigan: W.E. Upjohn Institute for Employment Research), 1991. A common finding is that a high prevailing wage scale discourages new business location. See, for example, Papke, "Interstate Business Tax Differentials." Other factors which such studies examine are quality of the labor force, energy costs, and access to the transportation networks and raw materials.

⁴⁶ United States General Accounting Office, *Enterprise Zones: Lesson From the Maryland Experience*, GAO/PEMD-89-2, December 1988.

⁴⁷ *Ibid.*, p. 4.

⁴⁸ Jerry Wade, "The Maryland Enterprise Zone Program: A Progress Report and Response to GAO," Maryland Department of Economic and Employment Development, April 17, 1989.

⁴⁹ See, Edward V. Regan, "Report of Examination: Economic Development Zone Program," State of New York, Office of the State Comptroller, September 1, 1990. The report concluded that it was not possible to evaluate the effectiveness of an enterprise zone program initiated in 1986 without allowing several more years to pass.

⁵⁰ O hUallachain and Satterthwaite, "Sectorial Growth Patterns at the Metropolitan Level."

ices, and engineering and architectural services. However, their results explicitly reject any employment effects resulting from changes in taxes or subsidies. The authors suggest the presence of enterprise zones may represent government responsiveness to firms seeking to expand or relocate.

As an alternative to empirical studies, a number of surveys have been undertaken to address the effectiveness of tax incentives on location decisions. Many economists suggest caution in interpreting the findings of survey research since responses to survey questions may not accurately forecast the economic behavior of decision makers. Nor may survey results based on State and local programs be applicable to a Federal program if the Federal program offers larger financial incentives. Nevertheless, surveys may provide some insight into the motivation of business managers who make decisions concerning location of investment. Generally, these surveys explicitly ask managers of firms about the importance of financial factors on location decisions. For the most part, these surveys have found that governmentally provided financial incentives (e.g., low interest loans, property tax abatements, income tax credits) are of secondary importance to a firm's location decision. Primary factors for location decisions have included items such as proximity to markets, availability of suitable raw materials, an appropriately trained labor force, and access to transportation networks. For example, the GAO surveyed employers in two of the enterprise zones in its study. The GAO reported that 60 percent of respondents rated financial incentives, including grants, subsidized interest rates, and other subsidies as of little or no importance to their location decision, while market access, community characteristics (community service, crime rate, etc.), and site characteristics each were listed as important by more than half the respondents.⁵¹ Researchers hypothesize that the primary factors, such as proximity to markets, attract a firm to a particular geographic region and that the secondary factors, such as financial incentives, may affect the particular choice of location within that region.⁵²

A third research approach to determining the effect of tax incentives on the location of investments is the case study method. While case studies are, by nature, anecdotal they may reveal general trends. Several States and outside analysts have used case studies to analyze the effects of State enterprise zone programs.⁵³ One case study has argued that the economic benefits of enterprise zones are important to firm location decisions. A study of Maryland's enterprise zone program cites financial incentives as important to Tandy Corporation's decision to locate a distribution center in Hagerstown, Maryland.⁵⁴ On the other hand, a case study of the General Motors' Saturn plant location decision concluded that tax incentives were a minor consideration in General Motors' final de-

⁵¹ GAO, *Enterprise Zones*, *op cit.*

⁵² Other examples of survey research in this area include Michael Wasylenko, "The Location of Firms: The Role of Taxes and Fiscal Incentives", in Roy Bahl (ed.), *Urban Government Finance: Emerging Trends* Sage Publications, 1981; and Larry Ledebur and William Hamilton, "The Failure of Tax Concessions as Economic Development Incentives," in Steven Gold (ed.), *Reforming State Tax Systems*, National Conference of State Legislatures, 1986.

⁵³ For examples of case studies of several State programs see Roy E. Green, editor, *Enterprise Zones: New Directions in Economic Development*, (London: Sage Publications), 1990.

⁵⁴ Wade, "The Maryland Enterprise Zone Program."

cision to locate in Spring Hill, Tennessee. Spring Hill's central location and proximity to transportation and cost reducing interstate highways were the primary considerations.⁵⁵

Efficiency of tax incentives for enterprise zones

Even if tax incentives can significantly affect the location decisions of firms, it is unclear whether the induced investment in enterprise zones constitutes net new investment or whether it is merely investment shifted from another locale. If investment in enterprise zones replaces investment that would have taken place elsewhere (for instance, if investment moves away from established centers of economic activity and toward designated enterprise zones), the primary effect of the investment incentives would be redistributive. To the extent that investment in enterprise zones is investment which is redistributed from local labor markets with low unemployment to local labor markets with high unemployment, the enterprise zone programs may direct investment from expensive local labor markets to those with an excess of relatively less expensive, under-utilized labor. In this event, the enterprise zone programs may generate welfare gains for the economy as under-utilized resources are tapped. Efficiency gains also may result if reductions in unemployment lead to reductions in social ills such as crime, which some analysts view to be an externality associated with unemployment and blight.

Some attempts have been made to determine the extent to which investments in State enterprise zones represent relocations of existing businesses from outside the zone. A survey of businesses located in enterprise zones by the Department of Housing and Urban Development found that only 9.1 percent of the businesses had relocated from outside the zone. An additional 7.5 percented branches of an existing establishment located outside the zone, 26.4 percented new businesses, 2.2 percent represented businesses which had been kept from closing, and 54.8 percent of investments represented expansions of existing zone businesses.⁵⁶ The small percentage of business relocations understates the extent to which enterprise zone investments are potentially redistributive. The HUD survey also revealed that such relocations of existing businesses averaged more new hires than either new firms or existing firm expansions. Moreover, the survey is not able to discern, except perhaps in the case of those businesses which would have otherwise shut their doors, whether these enterprise zone investments would have occurred outside the zone in the absence of the zone benefits. British enterprise zones have been found to experience a greater rate of relocations, 37 percent.⁵⁷

By design an enterprise zone will provide benefits to a business located within an enterprise zone while a similar business located just outside the enterprise zone boundary may not be eligible for

⁵⁵ Andrew Kolesar, "Can State and Local Tax Incentives and Other Contributions Stimulate Economic Development," *Tax Lawyer*, vol. 44, Fall 1990.

⁵⁶ Rodney A. Erickson and Susan W. Friedman, with Richard E. McCluskey, "Enterprise Zones: An Evaluation of State Government Policies," Final Report prepared for U.S. Department of Commerce, Economic Administration, April 1989.

⁵⁷ Peter Hall, "The British Enterprise Zones," in Roy E. Green, editor, *Enterprise Zones: New Directions in Economic Development*, (London: Sage Publications), 1990.

such benefits. The potential for relocation, discussed above, could lead to areas located near enterprise zones losing businesses and economic vitality. For example, one study of British enterprise zones found that 86 percent of businesses which relocated into enterprise zones came from the same county as that which contained the enterprise zone.⁵⁸ A result could be that the social and economic problems which led to the establishment of an enterprise zone are shifted to neighboring areas. On the other hand, if the enterprise zone does experience economic growth, other taxpayers may find it advantageous to locate near the enterprise zone to either serve enterprise zone businesses or to live near their place of employment. If this occurs, some of the benefits of the enterprise zone spillover into neighboring areas that are not designated as a part of the enterprise zone.

In addition to providing incentives to locate existing businesses in particular geographical areas, the incentives could induce the creation of new businesses which would not otherwise have been initiated in any location. Such new businesses could produce taxable profits and incomes which might reduce the revenue cost of the incentives. On the other hand, the incentives could induce investments inside enterprise zones which would be uneconomic in the absence of the tax incentives. Such an outcome would reduce the efficiency of aggregate national investment.

Competition between communities for the location of business may reduce the efficiency of tax incentives and other inducements. Thus, even if enterprise zones provide sufficient incentives to affect the location decisions of firms, an additional question is whether these incentives are cost-effective. To be cost-effective, the tax subsidies should be the smallest subsidies needed to achieve the desired behavioral change. Moreover, the subsidies should be narrowly targeted so that the benefits go primarily to firms that change their economic behavior in the desired fashion. That is, a cost-effective tax incentive program would minimize the amount of subsidy going to investors who would have located in the enterprise zone even in the absence of the tax subsidy program. When communities compete with one another using financial incentives, the chosen community may spend, in tax and other benefits, more than is necessary to induce the business to locate in a particular location.⁵⁹

One measure of the efficiency of tax incentives for enterprise zones is the cost, in terms of direct spending and foregone revenue, per job created. Several studies have attempted to calculate the cost per job created by enterprise zone programs. Such calculations are inherently difficult. It is difficult to determine how many jobs in an enterprise zone represent net additions to employment. To the extent that there are net additions to employment within the enterprise zone, there may be other jobs created or lost outside the enterprise zone. Such employment changes are equally difficult to

⁵⁸ Peter Hall, "The British Enterprise Zones."

⁵⁹ Kolesar, "Can State and Local Tax Incentives and Other Contributions Stimulate Economic Development." Kolesar reports that before deciding to locate its new plant in Georgetown, Kentucky, Toyota, which had given early indication of preferring the Georgetown location, threatened Kentucky with the prospect of locating in another State. This strategy resulted in greater public assistance for Toyota than Kentucky had initially offered.

quantify. In addition, it may be important to distinguish all new jobs from those new jobs gained by residents of the enterprise zone.

A recent study has attempted to measure the cost to taxpayers of the new jobs created by the Indiana enterprise zone program. The study calculates the annual cost in 1988 per job created ranged across zones between \$815 and \$11,747 with a mean of \$4,921. If, however, one looks at the cost per new job for an enterprise zone resident, the cost ranged between \$1,722 and \$173,539 with a mean of \$33,543.⁶⁰ A study of New Jersey's enterprise zone program put the costs per job at between \$8,000 and \$13,000, but if the program costs per year remain at the levels experienced in 1987 and 1988, then the costs per job would be \$40,000 to \$60,000 over a decade and continue to grow.⁶¹ Analysis of British enterprise zones concluded that the cost of each additional job created in an enterprise zone was 8,500 pounds sterling (approximately \$15,300 at current exchange rates) and the cost of each additional job in the wider area was between 23,000 and 30,000 pounds sterling (\$41,000 to \$54,000 at current exchange rates).⁶²

Tax incentives and the type of business formation

The choice of tax incentives granted to enterprise zone businesses may influence the type of business that will take place in an enterprise zone. For example, tax incentives for investment may induce more capital intensive businesses to locate in enterprise zones. Alternatively, if only employment subsidies are offered, more labor intensive businesses may be expected to locate in enterprise zones. Size limitations may induce small rather than large businesses to locate in enterprise zones. When a number of tax incentives are offered, the relative value of the different tax preferences may influence the type of businesses which locate within an enterprise zone.

Some argue that the need for enterprise zones grows out of the persistence of areas of pervasive unemployment and poverty, and therefore it is more appropriate to induce labor intensive businesses to locate in enterprise zones. It is argued that the resulting demand for labor simultaneously will attack both unemployment and poverty. Critics of this view note that there are no guarantees that the jobs created will be filled by residents of the enterprise zone. When jobs are filled by individuals from outside the enterprise zone, the objectives of reducing poverty and unemployment within the enterprise zone are not accomplished. Critics also observe that many labor intensive businesses are low wage employers which, by the nature of their business, offer little training to enhance the skills of employees. As a result, while employment might

⁶⁰ Leslie E. Papke, "Tax Policy and Urban Development: Evidence from an Enterprise Zone Program," photocopy, Michigan State University, December 1991.

⁶¹ See Marilyn Marks Rubin, "Urban Enterprise Zones in New Jersey: Have They Made a Difference?" in Roy E. Green, editor, *Enterprise Zones: New Directions in Economic Development*, (London: Sage Publications), 1990, and Franklin J. James, "The Evaluation of Enterprise Zone Programs," in Roy E. Green, editor, *Enterprise Zones: New Directions in Economic Development*, (London: Sage Publications), 1990. It is unclear whether these figures refer to jobs within an enterprise zone or jobs held by enterprise zone residents.

⁶² Peter Hall, "The British Enterprise Zones." As with the study of the New Jersey enterprise zone program, it is unclear whether these figures refer to jobs within an enterprise zone or jobs held by enterprise zone residents.

increase, poverty may only be somewhat mitigated and individuals' further economic advancement may still be limited by a lack of marketable skills. Proponents counter that society gains by reducing government welfare payments and individuals gain by establishing positive employment histories.

Others argue that it may be more appropriate to induce capital intensive businesses to locate within enterprise zones. Capital intensive businesses often require skilled workers and pay higher wages. Proponents also argue that businesses which make large investments are less likely to move once available subsidies expire or when another community offers financial inducements. As a consequence, such businesses may provide a more stable economic base to area development. Critics of this view observe that the residents of many areas which might qualify as enterprise zones may not have the skills necessary to gain employment in many capital intensive businesses, and little employment gain among residents may result. They also note that often individuals do not choose to reside in close proximity to many capital intensive businesses (for example, a steel mill) and large capital intensive businesses may, by locating within an enterprise zone, displace current residents. Such displacement, if it occurs, may only disperse the problems of economic development which were manifest in the area's designation as an enterprise zone.

Some assert that only small businesses should be permitted to take advantage of the economic inducements offered within enterprise zones. They note that small businesses are responsible for many of the jobs created within the United States and that small businesses are often innovators. Critics of this view observe that small businesses frequently fail. Consequently, small business may provide an unstable employment base for an enterprise zone. They contend that large employers are more stable employers. They further note that many small businesses need large businesses to purchase their products and often find it most economical to locate near major customers. Proponents counter that fostering many small businesses rather than one or two large businesses creates a broad economic base which is not subject to the business fluctuations of a single industry.

Others would like to encourage venture capital investments and the location of high technology businesses within enterprise zones. They contend that such businesses are the source of future economic growth and it is appropriate to direct some of this growth to economically under-developed areas. As discussed regarding capital intensive businesses above, high technology businesses may require skills not possessed by residents of an enterprise zone. Such businesses may find non-tax factors such as the proximity of scientists at a research university more important to their location decisions. Venture capital investments generally are high risk investments. Because a high risk implies a higher probability of failure, such investments may not provide stable employment opportunities within the enterprise zones.

Neutrality

Tax incentives for employment and investment in enterprise zones are intended to affect employment and investment decisions.

However, these incentives can create an inefficient allocation of resources because the preferences can make it more profitable, on an after-tax basis, to locate property at site A rather than site B, even though site B would produce greater pre-tax profits. On the other hand, the incentives may be necessary to promote the social goal of more economic growth and opportunity in distressed areas. If the enterprise zone does help reduce crime and other social ills in an area, then an efficiency gain can result despite the non-neutral treatment of employment and investment decisions.

Targeting tax incentives within an enterprise zone can also reduce economic welfare below that which might be attainable under proposals with broad based incentives. For example, an employment tax credit may skew the allocation of resources within an enterprise zone to labor-intensive industries. Similarly, tax incentives for capital may skew the allocation of resources within an enterprise zone to capital-intensive industries. A proposal which provides incentives of similar magnitudes for all types of capital and all types of labor is likely to result in larger economic benefit per dollar of revenue cost than more narrowly targeted incentives.

Incidence of enterprise zone benefits

The tax benefits associated with enterprise zones are aimed at creating investment, employment, and business activity within the enterprise zones. However, as with any tax or subsidy, the ultimate division of these tax reductions among various classes of potential beneficiaries depends on demand and supply conditions in the affected markets and the particular characteristics of the proposals. In general, the incidence of a tax (or of a tax subsidy) falls most heavily on the factor of production that is least mobile, that is, the factor that is least able to escape the burden of the tax by changing behavior. Because enterprise zones distribute tax benefits according to geographic location, factors which are relatively immobile across geographic locations are more likely to receive the benefit of proposed tax incentives than are factors which are geographically mobile.

Among the groups that may benefit from the establishment of enterprise zones are those owning land in the zone, those who may gain employment in the zone, those who invest in the zone, and the entrepreneurs who organize businesses within the zone.⁶³ Land is an immobile factor. It may be expected that tax benefits granted for economic activity undertaken in enterprise zones will tend to result in higher prices for land in the enterprise zone. If other factors of production are to some extent immobile, some of the value of enterprise zone benefits may accrue to these factors. For example, if residents of other areas are unable to commute easily to jobs in enterprise zones, then residents of enterprise zones may receive some of the benefits granted for employment or investment in enterprise zones.⁶⁴ Likewise, if entrepreneurs possess specific knowl-

⁶³ The discussion above suggested that some of the potential benefit of tax subsidies provided in enterprise zones may be lost due to non-neutralities.

⁶⁴ Some analysts have suggested a spatial mismatch exists between employers and potential employees and that this has helped create pockets of unemployment in inner cities. However see, David Ellwood, "The Spatial Mismatch Hypothesis: Are There Teenage Jobs Missing in the

edge that aids in the establishment of a business in the enterprise zone, they may also gain some of the tax benefits provided.

Analysis of the incidence of enterprise zone tax benefits is further complicated by several factors. First, many of the potential employees of the newly established enterprises may be hired at wages at or near the minimum wage. Second, the proposals vary in the extent to which they provide incentives for employment as opposed to investment. Third, some proposals would place a limitation on the total tax benefits available within any particular zone. Fourth, the proposals may vary in the magnitude of transactions costs (e.g., syndication or legal fees) required of the taxpayer to avail him or herself of the benefit.

A tax credit given to employers for wages paid for work within enterprise zones might benefit minimum wage workers more than other workers hired. Businesses locating within enterprise zones might find it profitable to hire workers at the minimum wage whom they would not hire at the minimum wage were it not for the credit they receive. The individuals hired receive a portion of the benefit of the credit in the form of employment at a wage at least equal to the minimum wage. However, for workers paid more than the minimum wage the credit may provide no benefit if the supply of such workers is great enough that businesses which may claim the credit can continue to hire these workers without having to bid up the wages they offer. In this case, all the benefit of the tax credit accrues to the employer.

If, on the other hand, the credit were to be claimed by the employee, the business would not hire at the minimum wage an individual who is currently unemployed because the employer would be unable to pay the individual less than the minimum wage. Such an individual would receive no benefit from the tax credit. Those employed at wages above the minimum wage may now face competition from individuals willing to work at a lower wage with the knowledge that a tax credit will make up at least a part of the difference. If such competition among workers occurs, the employer benefits from lower labor costs. An employee who is currently employed at the minimum wage would, by law, face no direct competition and thus might benefit from the wage credit. However, the employer might find it profitable to substitute more skilled (and more highly paid) workers for such an employee, if the credit causes the wages paid to more skilled workers to fall.

One might expect tax benefits directed at investment rather than wages to benefit investors primarily. However, as with wage subsidies that might accrue to labor, the benefits of investment incentives will accrue to suppliers of capital only to the extent that capital is available in restricted supply to the enterprise zones. In a relatively competitive capital market, the benefits of investment incentives, like wage subsidies, will be shifted to other, less mobile factors, such as land. Hence, the incidence of the two types of subsidies need not differ markedly.

Ghetto?" National Bureau of Economic Research, Working Paper No. 1188, August 1983. In analyzing black, teenage unemployment, Ellwood finds no effect on the employment rate of teenage blacks of the proximity of job opportunities or of spatial neighborhood effects.

The degree to which tax benefits shifted from labor and capital are divided among land and entrepreneurs depends in part on the restrictions put on zone development through tax benefit limitations. If limitations are not imposed, activity may proceed to the point where entrepreneurs receive nothing more than a normal return to their efforts, with the entire benefit being received by land owners in the form of higher land rents or dissipated through the establishment of relatively high cost businesses. However, limitations may restrict the extent of this shifting, providing entrepreneurs with a greater fraction of the tax benefits that are provided.

Deferral v. exemption

Enterprise zone tax incentive proposals generally provide certain forms of income deferral from tax or exemption from tax. The form in which the incentive is provided affects the magnitude of the incentive. Exempting income from taxation is always more valuable to the taxpayer than deferring taxation on the same income. For example, if \$1,000 could be invested for 10 years to earn eight percent annually and those earnings were exempt from taxation, this investment would have accumulated \$1,158.93 in interest by the end of the 10-year period. If the earnings instead were taxed annually to a taxpayer at a 28-percent marginal tax rate, the accumulated interest, net of taxes, would be \$750.71 after 10 years. If the earnings were not taxed annually, but rather the tax was deferred for 10 years and assessed on the accumulated interest at the end of the 10-year period, the value of the taxpayer's net earnings would be \$834.43. In this example, deferral increases the taxpayer's return by 11.2 percent over the 10-year period compared to annual taxation. Exemption is 38.9 percent more beneficial than deferral over the same period.

The benefit of tax exemption generally is greater to a higher-income taxpayer than a lower-income taxpayer, because the tax liability saved per dollar of tax-exempt income is greater for taxpayers in higher marginal tax rate brackets. The benefit of deferral depends not only on the taxpayer's current tax rate, but also on his or her future tax rate. The benefit of deferral is increased for a taxpayer who currently is taxed at a high marginal rate, but who can defer the tax liability until a lower marginal rate applies. The benefit of deferral is decreased if the taxpayer currently is taxed at a low marginal rate and defers the tax liability to a year when a higher marginal tax rate applies. In this circumstance, because of the taxpayer's low initial tax rate, the taxes deferred may actually be worth less, in present value, than the taxes owed at the later date when the taxpayer is in a higher tax bracket.

Equity considerations

Horizontal equity requires that taxpayers in similar economic situations be treated by the tax system in the same manner. To the extent taxpayers with identical economic incomes bear different income tax burdens as a result of the enterprise zone tax incentive programs, horizontal equity is not attained. This may be more of a concern in the short run than in the long run because such differential tax treatment may be capitalized in the price of assets lead-

ing to an equalization of after-tax incomes.⁶⁵ Vertical equity requires that taxes be assessed in accordance with the taxpayer's ability to pay. To the extent that the benefits of enterprise zone tax incentives accrue primarily to high-income taxpayers, vertical equity of the Federal tax system may be compromised.

Tax incentives may be structured as either deductions or credits. When taxpayers face different marginal tax rates, deductions yield different dollar amounts of tax benefit depending upon the taxpayer's marginal tax rate. As the taxpayer's income and marginal tax rate increase the tax subsidy increases. Credits yield the same dollar amount of tax benefit to all recipients.⁶⁶

Limitations on benefits

A goal of enterprise zones is to foster economic development within specified geographic areas. The tax benefits made available to enterprise zones may, however, be used to satisfy policy goals other than the economic development of the designated geographic area. For example, one may want to limit the ability of higher-income persons to utilize the tax benefits; to limit the magnitude of Federal assistance to any one geographic region; or to foster certain forms of economic development, such as the creation of labor intensive businesses rather than capital intensive businesses. Limitations on tax benefits available in enterprise zones may be used to satisfy policy goals in addition to the goal of the economic development of the designated geographic area. Proponents of limitations on tax benefits believe it is appropriate to address these additional policy concerns within the context of geographic economic development programs. Opponents observe that imposing limitations on tax benefits may reduce the magnitude of the tax incentives for economic development and thereby make it more difficult to achieve desired levels of economic development.

Limitation of the tax benefits available in enterprise zones generally may take two forms: limitations on specific tax benefits and limitations on the aggregate level of benefits. In the former case, the amount of tax benefit available to any one taxpayer may be limited or the class of qualifying taxpayers may be limited, but there generally is no limitation on the number of qualifying taxpayers who may receive the tax benefit. Many such limitations exist under present law. For example, the amount of money a taxpayer may annually contribute to a qualified pension plan is limited, but there is no limitation on the number of taxpayers who can make qualifying contributions. Present law also provides limitations on the aggregate amount of tax benefits available in certain cases. For example, the low-income housing credit is subject to an annual State credit allocation ceiling.

⁶⁵ For example, under present law the interest paid on State and local bonds generally is tax-exempt. However, the interest paid on such tax-exempt bonds is less than that paid on taxable bonds. For many taxpayers, after-tax income is approximately the same whether they purchase a taxable bond and pay tax or purchase a tax-exempt bond (with similar risk and maturity) and earn less explicit interest. To the extent that yield spreads do not completely reflect the effect of the tax, horizontal equity could be said to be violated.

⁶⁶ This is not strictly true if the taxpayer has an insufficient tax liability to utilize the credit and the credit is not refundable.

If a limitation on the aggregate level of benefits is utilized, it is necessary to create a method of allocating the available benefits among potentially competing taxpayers. For example, under present law, allocations of the low-income housing credit are made by State allocating agencies. Critics of this approach argue that the market system is impeded by introducing a government agency into the process. They argue that market allocation decisions generally are superior to other outcomes and agency involvement slows individuals' ability to react to market opportunities. They note that the concept of an enterprise zone is based on a philosophy of non-planning and private sector domination.⁶⁷ Proponents note that utilizing an allocating agency has the potential advantage of bringing State and local officials into the economic development process as partners whose participation may enhance the possibility of success because these officials have a stake in the success of the project. They observe that these officials may better know the needs of their jurisdictions and may be able to allocate the Federal benefits, or to combine the Federal tax benefits with State and local benefits, to achieve the economic development goals of their jurisdictions at least total cost. They further observe that such officials may provide oversight of the program to the benefit of taxpayers generally.

⁶⁷ Michael Allan Wolf, "Enterprise Zones: A Decade of Diversity," *Economic Development Quarterly*, vol. 4, February 1990.

B. Issues in the Design of Specific Enterprise Zone Tax Incentives

Tax credits for enterprise zone employment

The tax credits for enterprise zone employment in S. 2217, S. 1920, S. 1603, S. 1032, S. 686, S. 383, and H.R. 4210 consist of two separate types: a credit for increased employment and a credit for employee compensation. S. 686 creates a credit for increased employment, while the other bills create a credit for employee compensation. H.R. 4210, S. 686, and S. 383 would provide the credit to the employer. S. 2217, S. 1920, S. 1603, and S. 1032 would provide the credit to the employee.

Tax credit for increased employment expenditures

S. 686 would provide a 10-percent tax credit for increased employment expenditures. This credit is intended as an incentive for the expansion of employment and wages beyond a base period level of wage expenditures. Because only wages below the designated cap would be eligible for the credit, the credit would provide an incentive for part-time or modestly compensated labor. For example, if the wage cap were \$17,000, an increase in wages paid for additional work performed by a current employee from \$17,000 to \$18,000 would not be eligible for the credit, but hiring a new part-time employee to do the same work for \$1,000 would generate wages eligible for the credit.

The employer credit for increased employment expenditures is a marginal credit which for existing employers is determined by reference to the amount of qualified wages paid by the employer prior to designation as an enterprise zone. If in later years the amount of employment and qualified wages decline from a previous higher level, the amount of wages paid in excess of the amount paid before the area was designated an enterprise zone would still qualify for the credit. In the case of a business that starts up after an area is designated as an enterprise zone, *all* qualified wages would be eligible for the credit *every* year.

Tax credit for compensation paid employees

H.R. 4210 would provide a 7.5-percent tax credit to employers for wages paid to qualifying employees. Qualifying employees must receive annual wages of less than \$30,000, live in the enterprise zone, and work in the enterprise zone for an employer who does not employ more than 100 employees. S. 2217, S. 1920, S. 1603, and S. 1032 would provide a 5-percent credit to employees for the first \$10,500 of wages (based on the FUTA wage base) to employees who work in an enterprise zone. The credit is phased out for wages between \$20,000 and \$25,000.

Some argue that such credits would have the greatest effect on the distressed area if the employee were required to live and to work in the enterprise zone. Others claim, however, that incentives for businesses to establish operations within a zone and encourage more employment within a zone will benefit the distressed area regardless of where the employees reside. (A more general discussion of the incidence of the benefits of wage credits is presented in Part IV. A., above.)

Some question the need to provide a tax credit to individuals who would otherwise be well compensated and argue that it is prudent to reduce the credit amount for individuals with compensation above a certain level. Others maintain that new enterprise zone businesses require a mix of skill levels, and an incentive for individuals at all compensation levels is needed.

Investment tax credits and additional first-year depreciation allowances

Credit or allowance for general investment

S. 686 would provide a 10-percent credit for tangible personal property located and used in an enterprise zone, and newly constructed depreciable real property located in an enterprise zone. The credit, unlike the prior low investment tax credit, would include depreciable real estate in addition to equipment. H.R. 4210 would provide an additional first-year depreciation allowance equal to 25 percent of the adjusted basis of qualified zone property, including certain real property. This additional depreciation allowance is economically equivalent to an investment tax credit, where the credit percentage depends upon the depreciable life of the property.

Both proposals should be expected to lower the cost of capital for enterprise zone investments. If investment in certain geographic areas is inhibited because the perceived riskiness of the area increases the required cost of capital, proposals such as an investment tax credit may at least partially offset the high cost of funds. However, a high cost of capital to enterprise zone investments may not be the problem if investment is discouraged because of other deficiencies (e.g., poor public services or lack of a skilled work force), and an investment tax credit may do little to address these deficiencies.

A non-refundable investment tax credit or additional first year depreciation allowance may not have much affect on the cost of capital for firms with little or no tax liability. An investment tax credit or additional first year depreciation allowance may be a costly way to provide an investment subsidy as normal replacement investment qualifies for the tax preference as well as net new additions to the capital stock. While targeting the investment subsidy to incremental investment may be desirable, separating incremental investment from non-incremental investment may be problematic. However, to the extent that these proposals encourage more rapid replacement of the capital stock, they may encourage the more rapid adoption of equipment embodying new technology.

In the past, advocates of an investment tax credit have argued that it was necessary to encourage investment in equipment, rather than real property, as a means to encourage more productive business activities. Supporters of broader investment preferences for enterprise zones observe that it would be necessary to build up the capital stock in enterprise zones, including the stock of structures. Depreciable real estate, because it is not movable, would have long-term benefits for the enterprise zone area that could not be provided by increased investment in movable equipment. Similarly, a tax preference for tangible property used in the

enterprise zone is likely to have more benefit to the enterprise zone than a preference granted to intangible property as it is difficult to ensure that intangible property is employed inside the designated enterprise zone.

Credit for child care facilities

To encourage the provision of child care facilities by businesses located in enterprise zones, S. 383 would provide a 25-percent income tax credit for the adjusted basis in a qualified child care facility. The intent of this provision is to reduce the after-tax cost to taxpayers located in an enterprise zone who provide child care facilities for their employees. If firms can provide cost-effective on-site child care for their employees, it may increase the retention rate of the firm's employees, or permit the employer to provide tax-favored compensation to the employee in the form of subsidized child care. Both effects may provide enterprise zone employers with an advantage over competitors located elsewhere.

While the intention of the credit for child care facilities is to induce taxpayers to build such facilities, this may not be the most effective use of the taxpayer's funds, in that profitable opportunities may be passed over and investment made in tax-favored child care facilities. Moreover, if taxpayers would ordinarily construct child care facilities on-site, then the tax subsidy through an investment credit may be inefficient, because it would have little effect on taxpayer behavior.

Treatment of capital gains and purchases of enterprise zone stock

In general

Other than H.R. 4210, all the bills would create preferential treatment for capital gains with respect to enterprise zone property. S. 686 and S. 383 would permit taxpayers to defer recognition of gain for up to ten years on any property sold if the proceeds were reinvested in enterprise zone property. S. 2217, S. 1920, S. 1603, and S.1032 would exclude from taxable income any gain on qualifying enterprise zone property accrued during the period of enterprise zone designation.

In addition, H.R. 4210, S. 2217, S. 1920, S. 1603, and S.1032 would create a deduction for the purchase of qualifying stock in a qualifying enterprise zone corporation. If the deduction were claimed, the taxpayer's basis in the stock would be reduced by the amount of deduction claimed, and any subsequent gain would be taxed as ordinary income. Such tax treatment is equivalent to exempting the gain on qualifying stock from tax. To illustrate, assume a taxpayer with a marginal tax rate of 28 percent purchases \$1,000 of qualifying stock. The initial tax saving from deducting the cost of this stock is \$280, the tax that would have been paid on the \$1,000. For the purpose of this example, assume that the stock has appreciated at an annual rate of 10-percent and that the taxpayer sells the stock after one year.⁶⁸ The value of the stock upon sale will be

⁶⁸ H.R. 4210, S. 2217, S. 1920, S. 1603, and S.1032 would charge interest if a disposition occurs within five years. For the purpose of the example, no holding period requirement is assumed.

\$1,100 which must be included in income, creating a tax liability of \$308, and the taxpayer is left with \$792. Notice that if the taxpayer had paid the initial tax of \$280 and invested the remaining \$720 in the qualifying stock, the stock would have been worth \$792 after one year (assuming the same 10-percent rate of return). Upon sale the taxpayer would have to pay tax of \$20.16 (.28 times \$72) on the capital gain of \$72 and would be left with \$771.84 after payment of taxes. The value of the deduction for the purchase of qualifying stock is that the taxpayer does not have to pay the \$20.16 in tax on the capital gain. Thus, the deduction for the purchase of qualifying stock effectively allows the taxpayer to obtain a tax-free return on an investment of \$720.

Alternatively, the deductibility of the purchase of qualifying stock can be viewed as an investment that is jointly owned by the government and the taxpayer. The government's ownership share is equal to the tax rate (28 percent in the above example). When the stock is sold, the government receives its share of the funds. In the above example, when the funds are withdrawn after one year, the government receives 28 percent of \$1,100 (\$308), and the taxpayer receives 72 percent of \$1,100 (\$792). The taxpayer pays no tax on the earnings attributable to the taxpayer's share of the investment, and thus receives a tax-free return on the investment.

The taxpayer receives an additional advantage if the taxpayer's marginal tax rate in the year the stock is sold is lower than the marginal tax rate in the year the stock is purchased. Because the government's share of the investment is equal to the taxpayer's tax rate in the year the stock is sold, the lower the tax rate prevailing at that time, the smaller the government's share. On the other hand, the advantage of the deductibility of the purchase of qualifying stock is reduced if the taxpayer's marginal tax rate is higher at the time the stock is sold than at the time the stock is purchased.

Preferential treatment for capital gains realized outside an enterprise zone if the proceeds are invested in an enterprise zone may be expected to encourage an investor to roll over his or her equity into an enterprise zone investment. Limiting an investment incentive to the class of taxpayers with accrued capital gains rather than all potential investors may limit the effectiveness of the incentive in increasing total investment in an enterprise zone. On the other hand, taxpayers with funds to invest frequently have accrued capital gains.

Incentives for equity investments

Preferential capital gains tax rates for enterprise zone property and deductions for purchases of enterprise zone stock are intended to encourage investors to buy corporate stock in enterprise zone businesses, and especially to provide venture capital for new companies, thereby stimulating investment in productive business activities within the zone. Advocates of such preferences note that investment is necessary to create jobs and growth.

Opponents of preferential capital gains treatment for zone assets generally make three arguments. First, such preferences may create windfalls for owners of existing enterprise zone property. Demand for such property is increased by a tax preference which is available only to property within a specified geographic location,

thereby driving up its price. Opponents argue that such windfalls would do little to create new employment opportunities. Moreover, to the extent that housing, and more generally, land are qualifying assets, the increased demand for these assets could drive up the cost of owner occupied housing in designated enterprise zones. However, by making investments in housing more attractive the stock of housing may expand and rents charged to tenants may fall.

Second, a preferential tax rate for capital gains, even if targeted geographically, encourages taxpayers to enter into transactions designed to convert ordinary income into capital gains. Proponents counter that such "conversion" opportunities are simply part of the overall tax incentive for investments in enterprise zones which the preference is intended to encourage. They further observe the Tax Reform Act of 1986 made several changes to limit conversion opportunities.

Third, preferential treatment of capital gains may be inefficient because the preference is available to investments which would have occurred without the preference as well as to net, new investments. Opponents also question the efficacy of a deduction for the purchase of stock in enterprise zone corporations. To the extent that investors make large contributions of capital, the deduction may provide no benefit to the marginal, or last, dollar contributed. This could result in potential large investors not altering their behavior while receiving a windfall reduction in tax liability. Proponents of the deduction for the purchase of zone stock respond that even when this occurs the deduction will have encouraged equity investments rather than debt, and that greater equity participation will create a more stable business.

Cost of capital

Proponents of preferential treatment for capital gains for enterprise zone property and deductions for the purchase of stock in enterprise zone corporations argue that the cost of capital is high for enterprise zone investments. They argue that a preferential tax rate on capital gains increases investors' expected after-tax returns on such assets and thereby will lower the cost of capital for such investments. In addition, proponents note, a deduction for the purchase of stock in an enterprise zone corporation makes such stock relatively more attractive than other assets and thereby lowers the cost of raising investment funds. With a relatively lower cost of capital, more investment capital would flow into designated areas.

Opponents argue that because the preference for capital gains accrues only to property located in the enterprise zone, gains in reduced capital costs may be offset by increases in land costs, as the demand for such land increases. In addition, opponents argue that because of the ability to defer gains, the ability of individual taxpayers to receive step-up of basis at death, and the substantial participation of tax-exempt institutions in the investment markets, the effective tax rate on gains, which helps determine the cost of capital, may already be substantially below the statutory rate. On the other hand, proponents of a capital gains tax reduction for enterprise zone property note that because nominal gains are taxed, that even accounting for deferral, the effective tax rate on real (in-

flation adjusted) gains can be high. They further contend that any reduction in a tax on capital reduces the cost of capital for these investments.

Incentives for risk-taking

Proponents of preferential treatment argue that a reduced tax rate on gains encourages risk-taking, and that investors generally would view investments in designated zones as particularly risky. As a consequence, a preferential capital gains tax rate for enterprise zone property is justified to overcome this outcome of the marketplace. In addition, it is argued, preferential treatment is important for the entrepreneur who often contributes more in time and effort than in financial capital. However, the financial gains from risk-taking and the creative process are the major rewards entrepreneurs seek. Providing a tax benefit may inefficiently subsidize such activity beyond the socially optimal level.

Opponents of preferential treatment argue that if risk-taking is to be encouraged, a more efficient method might be to reduce the current asymmetric treatment of gains and losses, by expanding the provisions for loss offset in a targeted manner. However, preferred treatment for capital losses within enterprise zones may attract more risky investments to enterprise zones than throughout the economy at large. Because high risk implies a higher probability of failure, such investment may not provide stable employment opportunities within the enterprise zone.

Length of preference period

Choosing the length of time during which preferential treatment for capital gains is to apply involves trade-offs. The choice of preference period may affect the efficiency of the tax incentive as well as the ease or difficulty incurred by the taxpayer in complying with, and the Internal Revenue Service in administering, the provision.

Creating a permanent preference for capital gains which accrue on property in enterprise zones could bestow benefits on owners of assets long after the economic development of an enterprise zone has progressed to the point that such benefits are unnecessary. Permitting preferential treatment on gains accrued prior to enterprise zone designation may reduce taxes without generating commensurate employment or productivity growth in return. On the other hand, a permanent preference could be relatively simple to administer.

Proposals which would grant preferential capital gains treatment only during a limited period, such as during the period of enterprise zone designation, would create incentives to sell the enterprise zone property before the end of such period. This could reduce the attractiveness of enterprise zone investments, thereby reducing the effectiveness of the preference. The incentive to realize gain prior to the expiration of the period of preferential treatment could depress prices for enterprise zone assets and create instability in the market for such assets. Some argue that a preference for a limited period does not promote investment with a long-term view, but rather creates a short-term, unstable investment environment. In addition, limiting the preference to gains which

accrue during a specified period may require appraisals of enterprise zone assets at the beginning and end of the period. Such appraisals can be costly and create tax compliance difficulties.

Size of enterprise zones

An important consideration in designing a proposal intended to help spur development in economically depressed areas is the allowable size of an enterprise zone. To the extent the enterprise zone itself is geographically compact, the tax benefits provided may be more intensively targeted to a relatively small area. This may concentrate the impact of the valuable tax incentives provided through an enterprise zone program. Concentrating economic development may be a desirable strategy since the encouragement provided through an enterprise zone program may be greater than the sum of the various tax incentives provided, if neighboring businesses have beneficial effects on each other. Conversely, if the tax incentives provided through an enterprise zone program are geographically dispersed, the businesses involved may not be able to capture the operating economies that may exist when businesses are in close proximity.

It is possible that size constraints may operate to limit the types of areas that may qualify as enterprise zones. For example, rural or suburban areas tend to have low population density. In order to meet desired levels of economic development, public officials may believe that a minimum number of businesses must be affected. For the less densely populated areas of the United States, a tight size constraint for enterprise zones may preclude the possibility of these tax incentives affecting economic development to any significant extent.

To provide some perspective on the sizes of allowable enterprise zones under the legislative proposals under consideration, Table 1 lists the sizes of selected metropolitan areas. A 12-square mile enterprise zone is relatively large, compared to the size of many cities.⁶⁹ A 10,000-square mile enterprise zone is large compared to the size of some states (7 states have an area of less than 10,000 square miles, and 10,000 square miles is roughly the size of Maryland).

Enterprise zone proposals generally have some allowance for non-contiguous areas to be aggregated into a single enterprise zone. The rationale for this feature is to permit public officials to combine economically disadvantaged areas that may not neighbor each other into a single enterprise zone in order to take advantage of economies of scale in administering an enterprise zone. However, one potential pitfall in the allowance of non-contiguous areas to be part of a single enterprise zone is that areas with significantly different demographic or economic characteristics may be combined into a single zone and treated in similar fashion. This concern could be addressed with a requirement that an enterprise zone have a continuous perimeter no longer than X miles. In such a way, both the concern over size of an enterprise zone and the concern over non-contiguous areas being incorrectly aggregated would be mitigated.

⁶⁹ For example, Jersey City, New Jersey has a land area of approximately 13 square miles.

Table 1.—Land Area and Population of Selected U.S. Cities

City	Area (sq. miles)	Population (1990)
Baltimore.....	80.3	736,000
Boston.....	47.2	574,000
Chicago.....	228.1	2,784,000
Cleveland.....	79.0	506,000
Dallas.....	333.0	1,007,000
Detroit.....	135.6	1,028,000
Honolulu.....	87.0	365,000
Indianapolis.....	351.9	731,000
Kansas City, MO.....	317.4	435,000
Las Vegas.....	79.2	258,000
Los Angeles.....	467.3	3,485,000
Memphis.....	264.1	610,000
Milwaukee.....	95.8	628,000
Minneapolis.....	55.1	368,000
New Orleans.....	199.4	497,000
New York.....	301.5	7,323,000
Oakland.....	53.9	372,000
Philadelphia.....	136.0	1,586,000
Pittsburgh.....	55.4	370,000
St. Louis.....	61.4	397,000
San Diego.....	328.6	1,111,000
San Francisco.....	46.4	724,000
Seattle.....	83.7	516,000
Washington, DC.....	62.7	607,000

Source: Bureau of the Census, *Statistical Abstract of the United States, 1991*.

Complexity

By design, enterprise zone proposals offer tax preferences based on geographical location. This may create complexity for both tax administrators and taxpayers. At a simple level, additional tax preferences create complexity as more forms are required, more recordkeeping is necessitated, and more, and perhaps complex, computations are needed. However, the design of such preferences may create complexities in addition to whatever burden the filing of additional forms may entail.

Many enterprise zone proposals distinguish taxpayers who may qualify for enterprise zone tax preferences by size or other characteristics. The proposals lay out potentially complex rules defining qualifying taxpayers. Satisfaction of these rules may necessitate more careful recordkeeping for taxpayers to insure their compliance and may cause taxpayers to incur additional expenses to collect and verify information that is not needed for ordinary business purposes. For example, proposals that limit preferences to small businesses, may necessitate more careful record keeping to verify that indeed the business meets the criteria for classification as small. Proposals that give wage credits only to enterprise zone residents may place a burden on the employer of verifying the resi-

dence of the employee. To the extent that the tax preferences are phased out as the taxpayer's circumstances change, computational complexity is created for taxpayers.

If one believes that most of the taxpayers affected by the proposals are small businesses and individual taxpayers, such computational complexity may impose a greater relative cost than for large businesses. Small businesses may be compelled to rely on professional tax preparation more than they currently do, increasing their costs. To the extent that these businesses forego professional help, both compliance and the utilization of the tax preferences may suffer. Complexity also would increase for taxpayers who conduct businesses both inside and outside of enterprise zones, as their activities outside of the enterprise zone would be governed by one set of tax rules, while their activities inside the enterprise zone would be governed by a different set of tax rules.

These potential complexities faced by taxpayers also increase the burden of tax administrators to verify that preferences are properly claimed. For example, tax administrators would be responsible for determining the location of businesses in addition to their current task of verifying the proper reporting of income and expense.

